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Training Objectives:

At the end of this chapter, you will be able to do the following:

1. Determine when a corporation or bank is subject to inclusion in the water's-edge combined report using the deemed subsidiary rule.
2. Classify income of a foreign corporation as U.S. or foreign source.
3. Determine when a foreign corporation or bank is engaged in a trade or business within the U.S.
4. Determine when U.S.-source income is effectively connected with a U.S. trade or business.
5. Determine when foreign-source income is effectively connected with a U.S. trade or business.
6. Determine the effects of tax treaties on the determination of income effectively connected with a U.S. trade or business.

7. Determine when a foreign corporation has U.S.-source noneffectively connected business income.
8. Identify allowable deductions in arriving at an entity's taxable income subject to inclusion in the combined report.
9. Determine the income and apportionment factors of entities includible in the water's-edge combined report.

Section 8.1 Introduction To Deemed Subsidiaries

Contents:

a. Introduction

The deemed subsidiary rules are found in California Revenue and Taxation Code Section 25110(a)(4)[1]. This section provides that:

- a foreign-nation bank,
- or a foreign-nation corporation[2] which has an average of less than 20 percent of its property, payroll, and sales located in the U.S.,

is included in a water's-edge combined report only to the extent of its income derived from or attributable to sources within the U.S. as determined by federal income tax laws. This provision is commonly referred to as the deemed subsidiary rule since a foreign bank or corporation's U.S. branch business operation is effectively deemed to be equivalent to a U.S. subsidiary of the foreign bank or corporation.

In certain circumstances, a foreign bank or corporation may have both U.S.-source income and Subpart F income. Under such circumstances, a non-taxpayer foreign bank or corporation's U.S.-source income and apportionment factors includible in the water's-edge combined report will be determined using the deemed subsidiary rules discussed in this chapter. Such U.S.-source income will not be taken into account again when the Subpart F partial-inclusion rules are applied to the foreign entity's remaining income. The Subpart F partial-inclusion rules are discussed in Chapter 9, Water's-Edge Manual.[3]

In addition to foreign banks and certain foreign corporations, the deemed subsidiary provisions may also apply to electing IRC §936 corporations (possession corporations). Possession corporations are U.S. incorporated entities, but they rarely have US activity. Possession corporations are generally excluded from the water's-edge combined report under the provisions of R&TC §25110(a)(3)[4], but may occasionally be included under §25110(a)(2) if they have an average US apportionment factor of 20 percent or more.[5] The deemed subsidiary provisions apply to a bank or corporation that <u>does not</u> meet the criteria for inclusion in the combined report under R&TC §25110(a)(1)-(3) or (5),[6] so if a possession corporation has an average U.S. apportionment factor of less than 20 percent and cannot be included under any of the other provisions, it can still be included in the water's-edge combined report pursuant to the deemed subsidiary provision. Thus, the provisions of R&TC §25110(a)(4) will apply to an

IRC §936 corporation if it has less than 20 percent of its factors located in the U.S.[7]

An important point worth emphasizing is that the 20 percent test, R&TC Section 25110(a)(2), does not apply to banks. Therefore, the deemed subsidiary rule applies to foreign banks in a water's-edge group regardless of the extent of the bank's activity in the U.S. In contrast, the deemed subsidiary rule only applies to foreign corporations and possession corporations if they have less than 20 percent of their apportionment factors in the U.S.[8]

Because the amount of income includible in the combined report for banks and corporations subject to the deemed subsidiary rule is determined by the federal income tax laws, the auditor must understand and be able to apply the federal income tax provisions for foreign persons. As discussed in Chapter 1, Water's-Edge Manual and Chapter 6, Water's-Edge Manual, the federal method of taxing foreign corporations and the rules for determining the geographic source of income are quite different from the worldwide apportionment concept historically used by California.

The IRC divides income into two basic categories, income from U.S. sources and income from foreign sources. The term source is a geographic concept which assigns income to a particular situs. As noted in Chapter 6, Water's-Edge Manual, the federal sourcing rules first look to the type of income involved and then apply a specific set of rules to that type of income. Generally, the federal rules source income at the place where an activity occurred or where an asset is located.

For federal purposes, the sourcing rules serve two primary purposes: (1) to assist U.S. taxpayers in determining whether an item of income is to be treated as foreign-source income for purposes of the foreign tax credit limitation, and (2) to assist foreign persons in determining whether an item of income is from U.S. sources and subject to federal income tax.

Foreign banks and corporations are, in general, subject to U.S. tax only on their U.S.-source income. Thus, for example, a Canadian corporation engaged in a trade or business in the U.S., but with business income from both the U.S. and Canada, would be subject to U.S. tax only on the income it derives in the United States. In contrast, a U.S. corporation is subject to U.S. tax on its worldwide

income, although it does get a tax credit for foreign taxes paid on its foreign-source income.

U.S.-source income of foreign banks and corporations can generally be broken down into two categories. The first category of income is investment income from U.S. sources (fixed or determinable annual or periodical income (FDAP) not attributable to a U.S. trade or business, commonly referred to as FDAP income). The second category of income is income attributable to a trade or business conducted in the U.S. by a foreign bank or corporation (so-called "effectively connected" income or ECI).

The reason for the distinction between the two classes of income is that each class of income is taxed differently for federal purposes. FDAP income is subject to a flat-rate withholding tax on gross income for federal purposes. In other words, no deductions are allowed against such income in determining the tax liability for federal purposes. ECI, on the hand, is taxable at the normal, progressive tax rates paid by domestic corporations, and deductions attributable to ECI are allowed in determining the bank or corporation's federal tax liability. If a foreign bank or corporation has U.S.-source income (FDAP or ECI), it must file federal Form 1120F. However, no return is required if the foreign bank or corporation was not engaged in a U.S. trade or business, and the U.S. tax liability is fully satisfied through withholding at source.[9] Federal Form 1120F, filed by foreign banks and corporations, is comparable to the federal Form 1120 filed by domestic banks and corporations. Federal Form 1120F filing requirements are discussed in more detail in Section 8.3, Water's-Edge Manual.

For income years beginning on or after January 1, 1992, both ECI and U.S.-source noneffectively connected business income are subject to inclusion in a water's-edge combined report.[10] For purposes of determining ECI for income years beginning on or after January 1, 1992, U.S. tax treaties are not followed to the extent they limit the application of the effectively connected provisions of the IRC. For income years beginning prior to January 1, 1992, only ECI (as determined in accordance with U.S. tax treaties) is subject to inclusion in a water's-edge combined report.[11] No other U.S.-source income of a deemed subsidiary, including FDAP income, is includible in California water's-edge combined report for income years beginning prior to January 1, 1992. Any amounts included in the water's-edge combined report under the deemed subsidiary provisions must be adjusted to reflect differences between state and federal law in the computation of net income.[12]

To summarize what will be discussed in this chapter:

- A foreign bank or corporation's income must be classified by type.

- Once a foreign bank or corporation's income is classified by type, it can then be sourced under the federal rules as income from either U.S. or foreign sources. A detailed discussion of the federal sourcing rules is in Section 8.4, Water's-Edge Manual.

- Once income of a foreign bank or corporation is determined to be from either U.S. or foreign sources, a determination must be made as to what income, if any, is effectively connected with the conduct of a U.S. trade or business. Income effectively connected with the conduct of a U.S. trade or business is determined using the rules discussed in Section 8.5, Water's-Edge Manual.

- For income years beginning on or after January 1, 1992, U.S.-source income that is not effectively connected with the conduct of a U.S. trade or business is includible in the water's-edge combined report if it is business income as defined in R&TC §25120(a). A discussion of business and nonbusiness income and issues, and the functional and transactional tests can be found in the Multistate Audit Technique Manual.

This chapter discusses the federal rules for sourcing income and expenses, the distinction between effectively connected and noneffectively connected income, the definition of what constitutes a U.S. trade or business, the determination of income effectively connected with a U.S. trade or business, the determination of other U.S.-source noneffectively connected income (including FDAP income), the determination of expenses allocable to income includible in the water's-edge combined report, the determination of the apportionment factors subject to inclusion in the water's-edge combined report, and suggested audit techniques.

Footnotes

1. R&TC Section 25110(a) identifies which entities are included in the water's-edge combined report. SB 887 deleted R&TC Section 25110(a)(1) effective for income years beginning on or after 1/1/96. As a result, R&TC Sections 25110(a)(2) through 25110(a)(8) have been renumbered to R&TC Sections 25110(a)(1) through 25110(a)(7), respectively.
2. A foreign nation bank or corporation is an entity that is incorporated in a country other than the United States. For purposes of the discussion in Chapter 8, Water's-Edge Manual, a foreign corporation is an entity incorporated outside the U.S.
3. CCR §25110(d)(2)(H) provides that when a foreign bank or corporation, which is not a taxpayer, has U.S. source income that could be included under both the ECI rules and the subpart F rules, those items of income will be included under the ECI rules.
4. Formerly excluded under both R&TC Sections 25110(a)(1) and (4) before R&TC Section 25110(a)(1) was repealed, and R&TC Sections 25110(a)(2) though (a)(7) were renumbered to R&TC Sections 25110(a)(1) through 25110(a)(6), respectively.
5. If the possession corporation has an average of 20 percent or more of its apportionment factors in the U.S., then it is included 100 percent in the water's-edge combined report pursuant to R&TC Section 25110(a)(2).
6. When R&TC Section 25110(a)(1) was repealed, R&TC Sections 25110(a)(2) through 25110(a)(8) were renumbered to R&TC Sections 25110(a)(1) through 25110(a)(7), respectively.
7. See the discussion in Chapter 2, Water's-Edge Manual for more information on entities included in the water's-edge combined report. In addition, Chapter 7, Water's-Edge Manual, contains more detailed information on the treatment of IRC Section 936 corporations for water's-edge purposes.
8. Corporations that have an average of 20 percent or more of their factors in the U.S. must be included 100 percent in the combined report (R&TC Section 25110(a)(2)).
9. TreasRegs. §1.6012-2(G)(2)
10. CCR §25110(d)(2)(G)(i)(I)
11. CCR §25110(d)(2)(G)(ii)(I)
12. CCR §25110(d)(2)(G)(iv)

Section 8.2 Income And Factors Subject To Inclusion In The Combined Report

Contents:

Training Objective:

As discussed in the introduction, the deemed subsidiary provision applies to the following types of entities:

- all foreign-incorporated banks;
- foreign-incorporated corporations with an average of less than 20 percent of their property, payroll, and sales in the U.S.; and
- Electing IRC Section 936 corporations which have an average of less than 20 percent of their property, payroll, and sales located in the U.S.

The above listed entities are included in the water's-edge combined report only to the extent of their income attributable to U.S.-sources (determined in accordance with federal income tax laws), and their U.S.-located apportionment factors. Since the starting point for determining apportionable income of a deemed subsidiary is the amount of income from, or deemed from, U.S. sources, you must have a thorough understanding of the federal income-sourcing rules and concepts in order to effectively audit the water's-edge combined report on this issue. Chapter 6, Water's-Edge Manual presented a brief overview of the federal jurisdiction to tax foreign corporations, including a discussion of the sourcing rules, the ECI concept, the FDAP income concept, and the effect U.S. tax

treaties have on the determination of taxable ECI and FDAP income. A more in-depth discussion of these issues can be found in subsequent sections of this chapter.

At this point, let's just assume that we know the amount of ECI and U.S.-source noneffectively connected business income, and discuss how we get from that starting point to the amount of income and apportionment factors includible in the water's-edge combined report.

At the end of this section, the you will be able to:

1. Determine the income subject to inclusion in the water's-edge combined report for entities subject to the deemed subsidiary provisions.
2. Determine the apportionment factors subject to inclusion in the water's-edge combined report for entities subject to the deemed subsidiary provisions.

a. Important Regulation Changes

For income years beginning prior to January 1, 1992, an entity subject to the deemed subsidiary provision is only included in the water's-edge combined report to the extent of its income effectively connected, or treated as effectively connected, with a U.S. trade or business.[1] U.S. tax treaties, to the extent they limit the ECI determination, are followed. For income years beginning on or after January 1, 1992, the California regulations were modified to provide that entities subject to the deemed subsidiary provisions remain includible in the water's-edge combined report to the extent of their income effectively connected, or treated as effectively connected, with a U.S. trade or business. However, U.S. tax treaties, to the extent they limit the application of the ECI provisions of the IRC, are no longer followed. In addition, the revised regulations provide that U.S.-source noneffectively connected business income, net of applicable expenses, will also be included in the water's-edge combined report for income years beginning on or after January 1, 1992.[2]

As a result of this regulation change, there may be significant differences between the amount of ECI and FDAP income reported for federal purposes, and the amount of ECI and other U.S.-source business income includible in the water's-edge combined report under the deemed subsidiary provisions.

Example 1:

During 1996, Ideal Corporation, a corporation incorporated in Japan, filed federal Form 1120F claiming that they did not have taxable ECI as a result of the Japan-U.S. tax treaty's permanent establishment rules. However, Ideal Corporation did have income effectively connected, or treated as effectively connected with a U.S. trade or business under the IRC. Such income, although not taxable for federal purposes because of the tax treaty provisions, would be treated as ECI for California purposes, and would be includible in the water's-edge combined report.

Example 2:

During 1995, Award Corporation, a corporation incorporated in Switzerland, received dividends from its U.S. subsidiary domiciled in California. For federal purposes, the dividends constitute U.S.-source FDAP income subject to

withholding tax on gross receipts. For California purposes, the dividends would be included in the water's-edge combined report, net of allowable deductions, if the income represented business income as defined under R&TC §25120(a). However, if the dividend income is nonbusiness income to Award Corporation, then the income would be excluded from the water's-edge combined report even though the income was from U.S. sources.[3]

The remaining discussion in this chapter assumes that the reader understands the different treatment of U.S.-source income and apportionment factors in the water's-edge combined report for income years beginning prior to January 1, 1992, and for income years beginning on or after January 1, 1992, as a result of the modifications to the underlying California regulations.[4] See Section 8.5, Water's-Edge Manual and Section 8.6, Water's-Edge Manual, for more information on ECI and U.S.-source noneffectively connected business income.

b. Starting Point For Income And Apportionment Factor Determinations

As a general rule, the starting point for determining the income and apportionment factors included in a water's-edge combined report by an entity subject to the deemed subsidiary rules will be the amounts reflected on federal Form 1120F. The starting point for computing taxable income effectively connected with a U.S. trade or business is found on line 29 on page 3, Section II of the federal Form 1120F - "Taxable income before NOL deduction and special deductions." If U.S.-source noneffectively connected business income is also includible in the water's-edge combined report, the auditor should refer to Section I, page 2, lines 1 through 10, column b of the federal Form 1120F for purposes of determining gross U.S.-source FDAP income. The amounts reflected on the branch's books and records, and the federal Form 1120F, Schedule L (Balance Sheet), would be a starting point for determining the deemed subsidiary's includible apportionment factors.

For many foreign banks and corporations subject to the deemed subsidiary rules, the methodology for determining the amount of income and apportionment factors includible in the combined report will be the same as that used to determine net income before state adjustments and apportionment factors for the domestic members of the group. In some cases, the auditor will be able to accept the amount of ECI and FDAP income reported on the federal Form 1120F. Either there will be no audit worthy issues or the auditor will be able to rely on the IRS to audit the correctness of the federal Form 1120F as filed.

It is important to be note, however, that the IRS has historically devoted limited resources to examining federal Form 1120F's filed by foreign banks and corporations doing business in the U.S. Therefore, unlike the general assumption with respect to domestic corporations, one cannot assume that the IRS will, as a matter of course, audit the foreign entity in question.

If the IRS is not auditing the foreign bank or corporation, we cannot rely on them to ensure that the taxpayer's effectively connected income and expense computations reflected on the federal Form 1120F are correct or that FDAP income was correctly reported. If the issue is material, the auditor should review the federal ECI computation as there may be issues such as the appropriateness of the allocation and apportionment of overhead expenses, the computation of interest expense allocable to the U.S. activities, or the treatment of income as

FDAP instead of ECI. (All of these issues will be discussed in detail in subsequent sections of this chapter.)[5] You may also encounter situations where the bank/corporation has simply not complied with the federal Form 1120F return filing requirement. In which case, you would have to start from scratch and determine the amount of federal taxable ECI and FDAP income and the includible apportionment factors.

In fact, the question of whether a foreign corporation which has not filed a federal Form 1120F is engaged in a U.S. trade or business is an audit issue that should be considered anytime you identify a potential pricing issue between a foreign corporation and its U.S. affiliates. In many cases, alternative bases of adjustment to the pricing issue are asserting either that the foreign corporation:

1) has Subpart F income (the Subpart F provisions are discussed in Chapter 9, Water's-Edge Manual), or
2) is engaged in a U.S. trade or business by virtue of either its own activities or the activities of an affiliate acting on its behalf.

In some circumstances, you may find that the taxpayer has filed a federal Form 1120F which reports no ECI or FDAP income. You should refer to Question W on page 5 of the federal Form 1120F to see if the corporation is taking a position on their return that a U.S. tax treaty overrules or modifies the IRC thereby causing a reduction in their federal tax liability. If they are taking such a position, the auditor should refer to federal Form 8833, Treaty-Based Return Position Disclosure, which is required to be filed with the deemed subsidiary's federal Form 1120F. Federal Form 8833 should disclose the name of the treaty country, the IRC provisions being overruled or modified by the treaty, the name of the payor (if FDAP income), and an explanation of treaty-based return position taken, including the nature and amount of the income items for which treaty benefit is claimed.[6] Since California no longer follows U.S. tax treaties for income years beginning or after January 1, 1992, for purposes of determining whether an item of income is ECI, federal Form 8833 should provide additional information relevant to the determination of U.S.-source income includible in the water's-edge combined report.

As a final note, possession corporations may also be subject to the deemed subsidiary rule.[7] However, for federal purposes possession corporations are not subject to the federal ECI or FDAP rules because they are domestic corporations. Accordingly, ECI or FDAP income will never be self-reported by a possession corporation for federal purposes, and ECI and FDAP income will

never be a federal examination issue for these entities. For California purposes, the auditor will have to start from scratch to determine the includible U.S.-source income and apportionment factors of a possession corporation subject to the deemed subsidiary rules. Pursuant to R&TC Section 25110(a)(4), income and apportionment factors of possession corporations subject to the deemed subsidiary rules would be determined in accordance with the federal rules even though these rules do not otherwise apply to domestic corporations.

As a general rule, a possession corporation will typically have little, if any, U.S.-source income since their goal is to maximize possession-source income (i.e., foreign-source income) to maximize their possession tax credit. Therefore, possession corporations subject to the deemed subsidiary rule will usually only be subject to the minimum franchise tax, and will generally have little, if any, income and factors in the water's-edge combined report under the deemed subsidiary provisions. However, there will be exceptions to this general rule.

c. Income Subject To Inclusion In The Combined Report

As noted above, certain banks and corporations are included in the water's-edge combined report only to the extent of their income derived from, or attributable to, U.S. sources as determined by federal income tax laws. California Code of Regulations §25110(d)(2)(G) provides guidance on the actual computation of the income subject to inclusion in the water's-edge combined report for the relevant income year. Income of deemed subsidiaries includes income effectively connected, or treated as effectively connected, with a U.S. trade or business. For income years beginning on or after January 1, 1992, U.S.-source noneffectively connected business income will be included in the water's-edge combined report as well.[8]

As discussed in Chapter 6, Water's-Edge Manual and Section 8.5, Water's-Edge Manual, a foreign bank or corporation from a treaty country must have a permanent establishment in the U.S. before income effectively connected with a U.S. trade or business will be considered ECI for federal income tax purposes. A foreign bank or corporation may be engaged in a U.S. trade or business and not have sufficient activities in the U.S. to constitute a permanent establishment under the relevant tax treaty. In such situations, the foreign bank or corporation's U.S. activities would be immune from federal taxation under the applicable treaty. In contrast, a foreign bank or corporation from a non-treaty country needs only to be engaged in a U.S. trade or business before its income effectively connected, or treated as effectively connected, with a U.S. trade or business is subject to U.S. income tax. It is important to note that the permanent establishment rule is irrelevant to ECI determinations for corporations from non-treaty countries, for ECI determinations for income years beginning on or after January 1, 1992, and for possession corporations subject to the deemed subsidiary rules.

The deductions attributable to ECI and U.S.-source noneffectively connected business income includible in the water's-edge combined report are determined in accordance with Treasury Regulation §§1.861-8 and 1.882-5.[9] The amount of gross ECI less effectively connected deductions is the amount of taxable ECI includible in the water's-edge combined report. Although FDAP income is taxed on a gross basis for federal purposes, deductions would be allowed for California purposes in determining net U.S.-source noneffectively connected business income includible in the water's-edge combined report. It is important to note that

a deemed subsidiary can have negative income includible in the water's-edge combined report.

For California purposes, federal taxable ECI and U.S.-source noneffectively connected business income is the starting point for determining the income includible in the water's-edge combined report. (If the auditor identifies a corporation which has not complied with the federal return filing requirement, the auditor will, of course, have to calculate this amount themselves.) Once these amounts are determined, state adjustments may be required in order to reflect differences in the income computation for state and federal purposes. For example, deductions attributable to FDAP income are allowable for California purposes. In addition, net income includible in the combined report must be determined pursuant to the R&TC.[10] Thus, for example, adjustments must be made to add-back taxes measured by income, to compute depreciation using allowable California methods and lives, to compute the provision for the bad debt reserve using allowable California methods, to compute differences in basis in inventory or other property, etc. Finally, for income years beginning on or after January 1, 1992, ECI is included in the water's-edge combined report even if a U.S. tax treaty precludes federal taxation. Accordingly, the auditor must determine whether the deemed subsidiary from a treaty country has any ECI which is not taxable for federal purposes.

Example 3:

Island Corporation is a foreign corporation with less than 20% of the average of its apportionment factors in the U.S. Island Corporation has an effectively connected federal taxable loss of ($100,000), including an ACRS depreciation deduction of $200,000. The depreciation deduction using allowable California methods and lives is $75,000. A state depreciation adjustment of $125,000 ($200,000 - $75,000) is therefore required. As a result, Island Corporation's taxable ECI determined under California rules is $25,000. Island Corporation's income required to be included in the water's-edge combined report is $25,000.[11]

Example 4:

During 1995, Rex Corporation, a United Kingdom corporation, has interest income from U.S. sources which is not effectively connected with a U.S. trade or business. Pursuant to R&TC §25120, this interest income is considered business income. Rex Corporation files federal Form 1120F to report this FDAP

income. Although this income is taxed at a flat rate on gross income for federal purposes, for California purposes Rex Corporation would be allowed to claim deductions determined in accordance with TreasReg. Sections 1.861-8 and 1.882-5[12] for purposes of determining the amount of net income includible in the water's-edge combined report. Since net income included in the combined report must be determined under the R&TC,[13] additional state adjustments may be required.

Note: If Rex Corporation has fully paid its U.S. tax liability through withholding, the corporation is not required to file a federal Form 1120F. However, even if a federal return has not been filed, the interest income is still includible in the water's-edge combined report since it is U.S.-source noneffectively connected business income.

Example 5:

During 1995, Buzz Corporation, a Japanese Corporation, engaged in the business of manufacturing and selling contact lenses. Buzz Corporation placed advertisements for its products in professional journals and periodicals sold in the U.S. As a result of this advertising, Buzz Corporation sold contact lenses to U.S. customers during 1995. U.S. customer orders were filled from inventory stored in warehouses rented by Buzz Corporation in San Francisco and New York City. Contact lenses were stored in these facilities to ensure prompt delivery to U.S. customers on both the East and West coasts. Title to some of the goods passed to the customer in the U.S., and title to some of the goods passed outside the U.S.

Buzz Corporation's activities in the U.S. are sufficient to constitute a U.S. trade or business. However, the U.S.-Japan tax treaty provides that these activities do not create a permanent establishment. Accordingly, the income effectively connected with Buzz Corporation's U.S. trade or business would not be taxable for federal purposes because Buzz Corporation does not have a permanent establishment in the U.S. during 1995. For California purposes, however, when title passes in the U.S., income from the sale of inventory is U.S.-source income considered effectively connected with a U.S. trade or business, and is includible in the water's-edge combined report. U.S. tax treaties, to the extent they override or modify the federal ECI rules, are not followed for income years beginning on or after January 1, 1992. The sale of goods where title passed outside the U.S.

would be considered foreign-source income, and would only be considered ECI if the taxpayer had an office or fixed place of business in the U.S. (See Section 8.5, Water's-Edge Manual for a discussion of requirements that must be met in order for foreign source income to be considered ECI). Any foreign-source income from the sale of inventory which is attributed to a foreign corporations office or fixed place of business in the U.S. would be subject to the IRC §863 mixed-source income rules.[14]

Since Buzz Corporation self-reported federal ECI, the auditor could refer to the federal Form 8833, attached to the federal Form 1120F, as a starting point for determining ECI includible in the water's-edge combined report. Buzz's books and records would also provide information essential in this inquiry.

It is important to note at this point that the requirement to determine net income includible in the combined report pursuant to the R&TC does not override the basic ECI determination rules. The auditor must determine income includible in the water's-edge combined report under the federal rules before determining appropriate state adjustments. It is also important to note that there can be significant differences in the amount of income includible in the water's-edge combined report as a result of the regulation changes that occurred effective for income years beginning on or after January 1, 1992. The effect of this regulation change is illustrated in the following examples:

Example 6:

Craig Corporation, a Japanese corporation, is engaged in the business of manufacturing sake in Japan. During 1990, Craig Corporation shipped sake to California customers on a regular basis. The sake was stored for an average of 3 days in rented warehouse space at a San Francisco port facility before being delivered to California customers. Sales to California customers totaled $100 million during 1990. Pursuant to the terms of the U.S.-Japanese tax treaty, such activities are not sufficient to constitute a permanent establishment in the U.S. Since Craig Corporation does not have a permanent establishment and the income year began prior to January 1, 1992, there is no ECI includible in the water's-edge combined report.

Assuming Craig Corporation has made a water's-edge election for the 1990 income year, the combined report filed for 1990 by Craig Corporation would reflect no income subject to inclusion in the combined report even though Craig

Corporation clearly has a taxable presence in California as a result of having inventory and rented warehouse space located in this state, and substantial California destination sales. Craig Corporation is still considered a California taxpayer, and it must file a return and pay at least the minimum franchise tax for 1990.

Example 7:

Assume the same facts as Example 6, except that the activities in question occurred during 1996 instead of 1990. Pursuant to the terms of the U.S.-Japanese tax treaty, Craig Corporation's activities are still not sufficient to constitute a permanent establishment in the U.S. Accordingly, even if this income is effectively connected with a U.S. trade or business under the IRC, it is not treated as taxable ECI for federal purposes because of the treaty permanent establishment rule. However, Craig Corporation's regular and continuous activities in the U.S. do constitute a U.S. trade or business. Accordingly, the income effectively connected with Craig Corporation's U.S. trade or business is treated as ECI for California purposes, and is included in the water's-edge combined report even if the U.S.-Japan treaty precludes taxation at the federal level.

In this situation, Craig Corporation may have filed a federal Form 1120F that does not reflect a net ECI computation because it is claiming immunity from taxation under the U.S.-Japan tax treaty. Accordingly, the auditor will have to determine the taxpayer's ECI, U.S.-source noneffectively connected business income, applicable expenses, and apportionment factors includible in the water's-edge combined report from available books and records.

d. Factors Subject To Inclusion In The Combined Report - Overview

For purposes of applying the deemed subsidiary provisions, the U.S.-located apportionment factors of a foreign bank or corporation are determined using California's apportionment factor rules, subject to one very important modification. "The terms property owned or rented and used during the income year, compensation paid during the income year, and sales during the income year, as well as any other terms defining the denominator of any factor, are to be construed in a manner consistent with the determination of its United States located income."[15] In other words, only the apportionment factors related to the production of either ECI or U.S.-source noneffectively connected business income will be subject to inclusion in the combined report. For income years beginning before January 1, 1992, you may run into situations where you sure have something that looks and smells like a California factor, such as inventory and rented warehouse space in California, but because the corporation does not have a permanent establishment--and thus has no ECI--it does not have any U.S.-located apportionment factors includible in the combined report computation.

Consider again the facts in Example 6 above applicable to income years beginning prior to January 1, 1992. Under California's regular apportionment factor rules, the rented warehouse space at the California port facility and any inventory located in California or in-transit at year-end to a California destination would be includible in the numerator of the property factor. Similarly, the sales to California customers would be includible in the numerator of the sales factors. Under the deemed subsidiary rules, however, since Craig Corporation does not have a permanent establishment - and therefore has no ECI -there is no California apportionable income. As a result of having no income includible in the water's-edge combined report, there are also no apportionment factors subject to inclusion in the combined report since the apportionment factor rules must be construed in a manner consistent with the determination of Craig's income. If the deemed subsidiary has no includible income, it will have no apportionment factors.

The following example explains the determination of the apportionment factors under this rule.

Example 8:

Carlos B.V., a Netherlands Corporation, owns 100 percent of the stock in U.S. Corporation (US), a domestic corporation. US owns real property in California, and is a U.S. real property holding corporation (USRPHC). Carlos B.V.'s stock interest in US represents a U.S. real property interest (USRPI).

Carlos B.V. sells the stock in US to an unrelated foreign corporation. The income from the sale is treated as effectively connected U.S.-source gain from the sale of the underlying U.S. real property for federal purposes,[16] rather than as gain from the sale of stock. Accordingly, receipts from the sale would be assigned to the numerator and denominator of the sales factor in accordance with the rules for assigning receipts from the sale of real property, rather than using the rules for assigning receipts from intangible property.

e. Determination Of Includible Factors

As noted above, the includible apportionment factors are determined in accordance with the normal apportionment factor rules, except that the factors must be construed on the same basis as the deemed subsidiaries income included in the combined report.

1. PROPERTY FACTOR

UDITPA applies to the determination of property of a deemed subsidiary includible in the apportionment formula.[17] The determination of property subject to inclusion in the combined report may occasionally prove to be a little tricky. Obviously the property that is subject to inclusion is the property that relates to the production of ECI, FDAP, or U.S.-source noneffectively connected business income includible in the water's-edge combined report. Property which relates to the production of income excluded from the combined report, such as inventory generating foreign-source income that is not considered ECI, and property which relates to nonbusiness, noneffectively connected U.S.-source income, is not includible in the apportionment factor.

If the taxpayer prepared a California Schedule R for the deemed subsidiary, the auditor should verify whether the information reported on the Schedule R relates only to ECI or if it reflects all of the taxpayer's assets reflected on its U.S. books. If the taxpayer did not prepare Schedule R for the deemed subsidiary, then the instructions for the federal Form 1120F provide that the information included in the balance sheet may be limited to U.S. assets and other assets effectively connected with its U.S. trade or business. The auditor can use the federal Form 1120F, Schedule L (balance sheet) as a starting point for identifying assets associated with the generation of ECI and other U.S. source income included in the water's-edge combined report. Additional information may be required from the taxpayer's books and records, or from other information maintained by the taxpayer, to compute the deemed subsidiary's property factor. The auditor should never assume that the information reported on the taxpayer's return is accurate. But if the information appears reasonable in light of the information available, the auditor can make a determination whether the information should be accepted as reported.

Identifying assets included on the federal Form 1120F, Schedule L that are generating nonbusiness U.S.-source income may be difficult. (This is especially an issue for years prior to 1992 since FDAP is excluded from the combined report.) This could be a significant issue for banks and financial corporations since intangible assets are included in the factor. It will also be difficult to identify assets generating ECI if the taxpayer is claiming that the income is immune from federal taxation because of an applicable tax treaty. If the deemed subsidiary is currently reporting FDAP income, or has an M-1 adjustment for book income which is not included in its ECI computation, it may be immediately obvious that some assets are not includible in the apportionment factor computation. Segregating the cost basis of those assets may prove to be cumbersome, but at least you'll know such assets exist. On the other hand, if an asset is not producing income in the current year, you may not be aware that non-ECI assets exist.

It will similarly be difficult to determine assets generating ECI if the taxpayer is reporting a treaty-based return position. The cost basis and location of such assets may not be readily apparent.

Because of the above issues, determining the property includible in the apportionment formula may not be as easy as simply looking to the branch's books and records. Depending on the materiality of the issue, it may be worth analyzing the taxpayer investment accounts to determine if there are any non-ECI assets on the books, especially for banks and financial corporations.

For example, for years prior to 1992, if a unitary non-California branch of a foreign bank has a large investment account on its books, this issue may be worth pursuing in order to exclude the asset from the apportionment formula. In such case, you would apply the asset-use or business-activities test discussed in Section 8.5(c), Water's-Edge Manual to determine if the investments are effectively connected to the U.S. trade or business. In other words, if the investments had generated income in the current year, would that income have been considered ECI? If not, then the assets should be excluded from the apportionment formula. For income years after 1991, the issue would be whether the asset was generating ECI or U.S.-source noneffectively connected business income. The R&TC Section 25120 functional and transactional tests would apply to determine whether the U.S. source noneffectively connected income is business income subject to inclusion in the combined report. If the

income is not includible, the asset should be excluded from the apportionment formula.

Once you have determined the property factor subject to inclusion in the combined report, the normal California rules will be used to assign the assets and capitalized rent expense to the numerator of the property factor.

2. PAYROLL FACTOR

The determination of total payroll subject to inclusion in the combined report will generally be relatively straight-forward.[18] Total payroll will be those amounts included in the computation of net income includible in the combined report. This will include payroll attributable to ECI (for all years) and payroll attributable to U.S.-source noneffectively connected business income (for income years beginning on or after January 1, 1992). The normal California rules will then be used to assign these amounts to the payroll factor numerator.

3. SALES FACTOR

As in the case of the payroll factor, the determination of total sales subject to inclusion in the combined report will also generally be relatively straightforward. The sales factor will include gross receipts which give rise to ECI. In addition, for income years beginning on after January 1, 1992, U.S.-source noneffectively connected business income will also be included in the sales factor computation. As with the normal UDITPA rules, all intercompany receipts are excluded from the sales factor computation.[19]

The characterization of an item of income will always be determined in a manner consistent with the determination of income for federal tax purposes.[20] For example, sale of stock which is considered a disposition of a USRPI is treated as a sale of a real property interest for federal purposes, rather than as a sale of stock. Accordingly, the real property rules, rather than the intangible property rules, will be used to assign the receipt to the apportionment formula.

Once total receipts assignable to the sales factor denominator are determined,[21] the normal California rules will apply to determine whether such amounts are includible in the sales factor numerator.[22]

f. Summary

In this section we discussed the determination of the income and factors includible in the water's-edge combined report for entities subject to the deemed subsidiary provisions.

1. The starting point for determining the amount of includible income and factors of entities subject to the deemed subsidiary provisions is ECI and FDAP income reported on federal Form 1120F. Adjustments may be required to account for differences between federal and state taxable ECI and FDAP income, and ECI and U.S.- source noneffectively connected business income includible in the water's-edge combined report for income years beginning on or after January 1, 1992.

2. State adjustments may be required in order to reflect differences in the net income computation for California tax purposes and the computation of taxable income for federal purposes.

3. The regular California apportionment factor rules are used to determine the factors includible in the combined report, subject to the modification that the factors must be determined in a manner consistent with the determination of income included in the water's-edge combined report.

The following sections provide a detailed discussion of the federal rules for determining ECI and FDAP income. These rules are quite complicated and you are not expected to remember all the nuances of the federal provisions. The purpose of covering the federal provisions is to give you enough familiarity with the rules so that you will be able to identify potential issues with respect to the foreign bank or corporations computation (or lack thereof) of U.S.-source income. Once issues are identified, you can then spend time researching the federal law to gain a more in-depth understanding of the federal rules. The text of the following sections will help guide you through the federal laws and regulations in this area.

Footnotes

1. CCR §25110(d)(2)(G)(ii)(I)
2. CCR §25110(d)(2)(G)(i)(I)
3. CCR §25110(d)(2)(G)(i)(II)
4. CCR §25110(d)(2)(G)
5. The characterization of income as FDAP rather than ECI is only a concern for income years beginning before January 1, 1992, because only ECI is includible in the water's-edge combined report for those income years. For income years beginning on or after January 1, 1992, FDAP income is includible in the water's-edge combined report if it is considered business income.
6. TreasRegs. §301.6114-1(b)
7. Electing IRC §936 corporations may be included in the water's-edge combined report under R&TC Sections25110(a)(2) or (4) even though such corporations are specifically excluded from inclusion under R&TC §25110(a)(3). Authority for this is found in CCR Section 25110(d)(1).
8. CCR §25110(d)(2)(G)(i)(I)
9. CCR §25110(d)(2)(G)(iii)
10. CCR §25110(d)(2)(G)(iv)
11. CCR §25110(d)(2)(G)(vi)(Example 1)
12. CCR §25110(d)(2)(G)(iii)
13. CCR §25110(d)(2)(G)(iv)
14. TreasRegs. §1.864-6(c)(2)
15. CCR §25110(d)(2)(G)(vii)
16. IRC §861(a)(5)
17. See R&TC Sections 25129-25131, and the regulations thereunder, and R&TC Section 25137, where the normal apportionment provisions do not fairly represent the extent of the taxpayer's business activity in this state.
18. See R&TC Sections 25132 and 25133 and the regulations thereunder.
19. Chase Brass & Copper Co., Inc. V. Franchise Tax Board (1977), 70 CA 3d 457, 138 Crptr 901; CCR §25110(e)
20. CCR §25110(d)(2)(G)(vii)
21. R&TC §25134
22. R&TC §25135 and §25136

Section 8.3 Overview: Federal Taxation Of Foreign Corporations

Contents:

Training Objectives:

As discussed in the introduction, all foreign-incorporated banks and certain foreign-incorporated corporations with an average of less than 20 percent of their factors in the U.S. are included in a water's-edge combined report under the deemed subsidiary rules. Certain possession corporations may also qualify for inclusion under this rule. For income years beginning prior to January 1, 1992, deemed subsidiaries are included in the water's-edge combined report to the extent their income is considered effectively connected with a U.S. trade or business defined by federal tax law, applying any relevant U.S. tax treaty. For income years beginning on or after January 1, 1992, deemed subsidiaries are included to the extent their income is either considered effectively connected with a U.S. trade or business without regard to the effects of any relevant tax treaty, or is considered U.S.-source noneffectively connected business income. This section will provide a basic overview of the federal effectively connected income (ECI) and fixed or determinable annual or periodical (FDAP) income concepts, and the manner in which foreign banks and corporations are taxed for federal purposes. At the end of this section you will be able to:

1) Determine the difference between ECI and non-ECI, and
2) Understand the tax implications of distinguishing between ECI and non-ECI.

a. General Overview

For federal purposes, domestic banks and corporations, and foreign banks and corporations are taxed differently. Domestic banks and corporations (whether U.S. owned or foreign owned) are taxed on their worldwide income at the rates provided by IRC §11 (graduated rates) or IRC §55 (AMT). Foreign banks and corporations are generally taxed by the U.S. only on the portion of their income derived from economic activities having some nexus with the United States.

The federal rules for determining the amount of a foreign corporation's income that is subject to U.S. income taxes and the manner of taxing such income are highly technical. The operation of these rules relies on the U.S.-sourcing rules found in IRC §861-865. (The source rules are discussed in detail in Section 8.4, Water's-Edge Manual.) The general rule is that foreign corporations are taxable only on their U.S.-source income. There is an exception to that rule for certain foreign-source income earned through a U.S. office. Foreign banks and corporations, which have no income from U.S. sources, generally are not subject to U.S. tax. The IRC also provides that under some circumstances a foreign bank or corporation's U.S.-source income is not subject to U.S. taxation.

As previously discussed, taxable U.S.-source income of deemed subsidiaries can be broken down into two classes of income. The first class of income subject to taxation in the U.S. is defined in IRC §881. The types of income to which IRC §881 applies are referred to as "fixed or determinable annual or periodical income" (FDAP). Specifically included by the IRC in the definition of FDAP income is:

1. Income from investments, such as interest, original issue discount (OID), dividends, rents, and royalties.[1]
2. Income from compensation for personal services received during a year the corporation was not engaged in a U.S. trade or business.
3. Certain limited kinds of capital gains, including gain from the disposal of timber, coal and domestic iron ore, and gain from the sale of intangible property, such as patents and copyrights, to the extent such gains are equivalent to royalty payments.[2]

FDAP gross income[3] is subject to federal withholding tax at a flat 30 percent rate (or lower U.S. tax treaty rate if available).[4] The rules applicable to FDAP income

are discussed in greater detail in Section 8.6, Water's-Edge Manual. According to federal statistics, FDAP income exceeded $70 billion in 1991.[5] Foreign banks and corporations received approximately 76% of this income. In most instances, the tax withheld on FDAP income represents the recipient's total tax liability. Thus, the foreign recipients would not have to file a federal income tax return because their tax liability was fully satisfied by withholding-at-source.[6]

The second class of income subject to taxation by the U.S. is income effectively connected with a U.S. trade or business (ECI). The federal rules for taxing ECI are set forth in IRC §882 and the regulations thereunder. In general:

1. Foreign corporations engaged in a U.S. trade or business, which do not have a U.S. office, are:
   a. Taxed at regular corporate rates (or at AMT rates) on their U.S.-source net income effectively connected with their U.S. trade or business.
   b. Taxed at a flat 30 percent or lower U.S. tax treaty rate on gross U.S.-source FDAP income that is not effectively connected with the U.S. trade or business (e.g., FDAP income which meets the definitions of IRC §881 and is also effectively connected with a U.S. business is taxed at the normal corporate rates in accordance with IRC §882).

2. Foreign corporations engaged in a U.S. trade or business, which have a U.S. office, are taxed the same as in item 1, except that ECI may also include certain foreign-source income attributable to the U.S. office. (Some tax treaty provisions may exempt foreign-source ECI from federal taxation. For income years beginning on or after January 1, 1992, such an exemption would not apply to any ECI determination for California purposes.)

The ECI rules are discussed in more detail in Section 8.5, Water's-Edge Manual.

b. U.S. Tax Treaties

The U.S. has negotiated treaties with a number of foreign countries. The significance of these treaties cannot be overemphasized: treaty provisions often grant more favorable tax consequences than are available under the IRC. For example, many treaties contain a provision that reduces or eliminates the 30 percent withholding tax mandated by IRC §881.

For income years beginning prior to January 1, 1992, the deemed subsidiary rules provide that provisions of U.S. tax treaties are followed for California purposes to the extent they limit the application of the ECI provisions of the IRC.[7] In situations where a deemed subsidiary has no ECI due to a U.S. tax treaty overriding an IRC provision, the deemed subsidiary would not be included in the water's-edge combined report because it has no income or apportionment factors.

In many cases treaty provisions override the IRC, although in some instances new federal legislation will specifically override existing treaty provisions. (The impact of treaties on specific IRC provisions is discussed in detail in Section 8.5, Water's-Edge Manual). Consequently, when examining a deemed subsidiary for income years beginning prior to January 1, 1992, you must be aware of the possible impact of U.S. tax treaty provisions on ECI determinations. For income years beginning prior to January 1, 1992, ECI that is exempt from U.S. tax under the provisions of a treaty is not included in a deemed subsidiary's gross income for either federal purposes or California water's-edge combined reporting purposes.

U.S. tax treaty provisions play a significant role in the determination of federal taxable ECI. If the deemed subsidiary is from a country with which the U.S. has a treaty, ECI will be free of tax unless the deemed subsidiary has a "permanent establishment" in the U.S. The tax treaty should provide both a definition of "permanent establishment" and a list the types of activities which are not considered to create a permanent establishment. In general, a permanent establishment is a fixed place of business, such as an office or a place of management, through which the entity's business is wholly or partly carried on. The permanent establishment rules and the impact of tax treaties on the determination of taxable ECI are discussed in greater detail in Section 8.5, Water's-Edge Manual.

c. Federal Filing Requirements

Every foreign corporation, which is engaged in a U.S. trade or business at any time during the year, or which has income which is subject to U.S. income tax must file a federal Form 1120F. This is regardless of the amount of its gross income or whether it has taxable income.[8] Furthermore, federal Form 1120F must be filed even if the foreign bank or corporation is claiming immunity from U.S. taxation under an applicable U.S. tax treaty.

Federal Form 1120F filed by foreign banks and corporations is similar to the federal Form 1120 filed by domestic banks and corporation. The major difference is that there are two additional sections on federal Form 1120F. Form 1120F, Section I, reports U.S.-source gross income not effectively connected with a U.S. trade or business (FDAP income). As discussed above, no deductions are allowed against such income for federal purposes. The U.S. subjects this income to a flat tax, withheld-at-source, equal to 30 percent of gross FDAP income. However, a treaty may substantially reduce or eliminate this withholding tax.

Federal Form 1120F, Section II, equivalent to the Profit & Loss Statement, Balance Sheet, and Schedule M information of the federal Form 1120, reflects the foreign bank or corporation's U.S. trade or business activities. For state purposes, the starting point for the computation of apportionable ECI is line 29 on Schedule II of the federal Form 1120F.

Federal Form 1120F, Section III, reports the branch profits tax. This is effectively a withholding tax on a deemed "dividend equivalent amount" and has no relevance for California purposes. A copy of federal Form 1120F is located in the Forms Appendix.

The federal return filing requirements are modified in some situations. A federal Form 1120F filing is not required when the tax is fully paid at the source (e.g., tax has been fully paid through withholding) and the bank or corporation has no ECI.[9] Furthermore, if the foreign bank or corporation has no taxable gross income for the year, it is not required to complete the federal Form 1120F schedules. However, it must attach a statement to the return indicating what types and amounts of income are being excluded from gross income.[10]

If the foreign corporation takes a "return position" that any U.S. tax treaty overrides or modifies any provision of the IRC and thereby effects (or potentially effects) a reduction of tax, it must disclose this on the federal Form 8833, Treaty-Based Return Position Disclosure, attached to the federal Form 1120F (effective for returns for which the due date of the return, without extensions, occurs after December 31, 1988).[11] Even if a return would not otherwise be required to be filed, a return must nevertheless be filed for purposes of making the required treaty-based disclosure. Such return needs to include only the corporation's name, address, identification number, and the disclosure, signed under penalty of perjury.[12] A separate disclosure must be made for each treaty-based position taken. The disclosure reporting requirement is waived in limited circumstances.[13] However, the waiver does not generally apply to "return positions" relating to ECI.

The statement required to be attached to the federal Form 1120F must disclose the nature and amount of each income item for which the tax treaty benefit is claimed, an explanation of the position taken with a brief summary of the facts on which it is based, the specific tax treaty provision relied upon, and the IRC provision overridden or modified.[14] A penalty of $10,000 is imposed on corporations for each failure to comply with the return position disclosure requirement.[15] A copy of federal Form 8833, Treaty-Based Return Position Disclosure, is included in the Forms Appendix. Refer to IRC §6114 and the regulations thereunder for more information on treaty-based return positions.

You may now be wondering what types of foreign entities are actually filing federal Form 1120F's and are going to be subject to the deemed subsidiary provisions. According to federal statistics, 9,321 returns were filed by foreign banks and corporations in 1989 reporting ECI. Real estate companies accounted for 61% of the total returns filed. Banks account for around 3%, and other industrial activities accounted for the balance. In an interesting contrast, banks accounted for about 74% of the total receipts reported in 1989, even though they filed only 3% of the returns. Real estate companies, which represented 61% of the returns filed, accounted for 2% of total receipts reported.[16] In short, the deemed subsidiary provisions will primarily be material to the examination of foreign banks.

d. Income Effectively Connected With A U.S. Trade Or Business

A foreign bank or corporation engaged in a trade or business in the U.S. is taxed under IRC §882 to the extent of its income effectively connected with its U.S. trade or business. A foreign bank or corporation can be engaged in a U.S. trade or business even if it does not have an office or other fixed place of business in the U.S. If the foreign bank or corporation does not have a U.S. office or other fixed place of business, it is only taxed on its U.S.-source ECI.

If the foreign bank or corporation has a U.S. office or other fixed place of business, it is taxed on its U.S.-source income and on certain foreign-source ECI. For foreign-source income to be treated as ECI, it must be attributable to an office or other fixed place of business which the foreign bank or corporation has in the U.S. at some time during the taxable year. Only the following classes of foreign-source income can be treated as ECI:

1. Rents or royalties for the use of or for the privilege of using intangible property, including copyrights, patents, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like property;
2. Dividends or interest derived in the active conduct of a banking, financing or similar business within the U.S., or received by a corporation whose principal business is trading in stocks or securities for its own account; or
3. Sale of inventory through a U.S. office.

No other types of foreign-source income may be considered ECI.[17]

1. What Constitutes A U.S. Trade Or Business

The determination as to what constitutes a U.S. trade or business is a question of fact. Case law has generally held that substantial, regular, or continuous activities and transactions, other than those of a passive nature, are characteristics of a trade or business. Whether a foreign corporation has sufficient contacts in the U.S. by virtue of exercising the privilege of conducting activities within the U.S., (and thereby enjoying the benefits and protection of U.S. laws, so as to obligate it to help pay for those privileges and that protection, is an issue of fact. This is much the same as the test used by the states,

including California, for determining whether a corporation domiciled outside the state has sufficient contacts within the state to be subject to tax (i.e., whether the entity has "constitutional nexus").

The courts have held, for example, that the continuous sale of inventory in the U.S. constitutes a U.S. trade or business. Alternatively, if the sales are sporadic or immaterial, the courts have held that the corporation is not engaged in a U.S. trade or business.[18] The activities of a dependent agent on behalf of the corporation are imputed to the corporation. Thus, a corporation is deemed to be engaged in a U.S. trade or business if an agent of the corporation is performing activities that would have caused the corporation to be engaged in a U.S. trade or business if it had performed them itself.[19] (For a discussion on when an agent creates a permanent establishment in the U.S., see Taisei Fire and Marine Insurance Co., Ltd., 104 TC 27 (1995), [20]and Inverworld, Inc. Et Al v. Commissioner of Internal Revenue, T.C. Memo 1996-301[21]).

2. Determination Of Federal ECI

Once it is established that a foreign bank or corporation is engaged in trade or business in the U.S., the next step is to determine its taxable ECI. At this point it is important to remember that if the foreign bank or corporation is incorporated in a country with which the U.S. has a tax treaty, its ECI is not taxed by the U.S. unless it has a permanent establishment in the U.S. as defined by the applicable tax treaty. Therefore, the first step in determining taxable ECI is to determine whether a tax treaty applies. Does the foreign bank or corporation reside in a country that has a tax treaty with the U.S.? If it does, the next step is to review the applicable treaty to determine if its activities in the U.S. are sufficient to create a permanent establishment.

If the bank or corporation has a taxable presence in the U.S. (either because it has a U.S. trade or business or because it has a permanent establishment in the U.S.), its income effectively connected with the U.S. business must be determined. In most cases, this determination will be relatively straight-forward as the income will clearly be income from the corporation's trade or business. There will be situations, however, where the deemed subsidiary will have investment income or extraordinary income that they believe is not related to their trade or business and therefore should not be considered ECI.

The Treasury Regulations provide two tests to assist in determining whether or not income is effectively connected with a U.S. trade or business: the asset-use test and the business-activities test.[22] The tests set forth in the regulations are the relevant standard to apply. Administrative, judicial, or other interpretations regarding the character of income made under the laws of any foreign country are not relevant to the determination of whether an item of income, gain, or loss is effectively connected with the conduct of a trade or business in the U.S.[23]

The asset-use test looks to whether the income is derived from assets which are used in or held for use in the conduct of the taxpayer's U.S. trade or business. The business-activities test looks to whether the business activities of the taxpayer in the U.S. are a material factor in the generation of the income. These tests are discussed in greater detail in Section 8.5, Water's-Edge Manual. In applying the asset-use test or the business-activities test, the regulations provide that "due regard" will be given to how the taxpayer has handled the item on its books and records. The accounting test will not by itself, however, be controlling.[24]

e. Fixed Or Determinable Annual Or Periodical (FDAP) Income

IRC §881 imposes a withholding tax of 30 percent (or a lower tax treaty rate if available) on certain gross income from U.S.-sources received by a foreign bank or corporation. To be taxable under IRC §881, the U.S.-source income received must meet certain criteria and must not be effectively connected with a U.S. trade or business. (The taxability of all ECI is governed by the provisions of IRC §882). No deductions are allowed against FDAP income in determining the amount of tax due. The payor of the income is the designated withholding agent and is required to withhold the tax from the payments made to the foreign person.

The types of income that generally constitute FDAP income include:

1) Interest, dividends, rents, royalties, or any other fixed or determinable annual or periodical income;
2) Gains from the disposition of timber, coal, or iron ore;
3) Original issue discount (OID) accruing during the period the obligation is held by the foreign corporation; and
4) Gains from the disposition of patents, copyrights, goodwill, and other like property if the gains are from payments which are contingent on the productivity, use, or disposition of the property sold or exchanged (e.g., the payments are equivalent to royalties).[25]

Unless noted in items 1–4 above, FDAP does not include gains realized from the sale or other disposition of property.

Business FDAP income is included in the water's-edge combined report for income years beginning on or after January 1, 1992. The concept of FDAP income is discussed in greater detail in Section 8.6, Water's-Edge Manual.

f. Summary

This section provided a basic overview of the two categories of U.S.-source income of foreign banks and corporations and the manner in which the federal government taxes such income. The next section will cover the rules for sourcing various items of income.

1. Every foreign corporation which is subject to U.S. tax must file a federal Form 1120F unless all tax is fully paid at source.

2. With certain exceptions, foreign corporations are generally taxable only on their U.S.-source income.

3. Taxable U.S.-source income of foreign corporations can be broken down into two classes - fixed and determinable annual and periodical income (FDAP) and income effectively connected with a U.S. trade or business (ECI).

4. Foreign corporations are taxed at the same progressive rates as domestic corporations on net income effectively connected with a U.S. business. However, the gross FDAP income is taxed at 30 percent or a lower tax treaty rate, if available.

5. U.S. tax treaty provisions may override the provisions of the IRC in determining the amount of taxable U.S. income for federal purposes. For income years beginning prior to 1992, California rules require that the provisions of U.S. tax treaties be applied when determining ECI. For income years beginning after 1991, for California purposes, the provisions of U.S. tax treaties cannot be applied.

6. The IRC does not specify which activities a foreign corporation must be engaged in to be considered engaged in a trade or business in the U.S. Case law has generally held that substantial, regular, or continuous activities are characteristics of a trade or business.

Footnotes

1. IRC §881(a)(1) and IRC §881(a)(3)
2. IRC §881(a)(2) and IRC §881(a)(4)
3. The U.S. tax on FDAP income is based on the gross amount. No deductions are allowed to reduce gross FDAP income.
4. IRC §881(a)
5. "Foreign Recipients of U.S. Income, 1991", Denise Bori, SOI Bulletin, page 34.
6. TreasRegs. §1.6012-2(G)(2)(i)
7. CCR §25110(d)(2)(G)(ii)(I)
8. TreasRegs. §1.6012-2(G)(1)
9. TreasRegs. §1.6012-2(g)(2)(i)(a) & (b)
10. TreasRegs. §1.6012-2(g)(1)
11. TreasRegs. §301.6114-1(a)(1)(i)
12. TreasRegs. §301.6114-1(a)(1)(ii)
13. TreasRegs. §301.6114-1(c)
14. TreasRegs. §301.6114-1(d)
15. TreasRegs. §301.6712-1(a)
16. "Statistics of Income Studies of International Income and Taxes", SOI Bulletin, Sarah E. Nutter, Winter 1993-1994, page 19.
17. IRC §864(c)(4)
18. Comm. v. Spermacet Whaling & Shipping Co., 60-2 USTC 9645; Frank Handfield, 23 TC 633; WC Johnston, TC 920; Linen Thread Co, Ltd., 14 TC 725.
19. Revenue Ruling 70-424, CB 1970-2 150; Frank Handfield, 23 TC 633.
20. A discussion of *Taisei Fire and Marine Co., Ltd.,* can be found in "*Taisei:* U.S. Agent Did Not Create Permanent Establishment", Robert S. Schwartz, Journal of International Taxation, July 1995.
21. Supplemental Memorandum Opinion T.C. Memo 1997-226 (1997).
22. TreasRegs. §1.864-4(c)
23. TreasRegs. §1.864-3(a)
24. TreasRegs. §1.864-4(c)(4)
25. TreasRegs. §1.881-2(b) & (c)

Section 8.4 Sources Of Income

Contents:

Training Objectives:

As discussed in the preceding section, for federal purposes, a foreign bank or corporation is generally taxable only on its U.S.-source income. Therefore, the first step in determining if such entities have income effectively connected with a U.S. trade or business is to determine if they have any U.S.-source income. This section discusses the federal sourcing rules for specific items of income. Section 8.5, Water's-Edge Manual, will discuss the ECI rules, and Section 8.6,Water's-Edge Manual, will discuss the FDAP rules. The federal concept of sourcing

income is quite different from our state income-sourcing concepts. You will need to understand the federal sourcing rules to effectively audit water's-edge returns.

At the end of this section, you will be able to:

1. List and describe the general sourcing rules for specific items of income, such as interest, dividends, rents, royalties, and personal services; and
2. Describe the rules for determining if an asset qualifies as a U.S. real property interest.

a. Sources Of Income - In General

As discussed in Chapter 6, Water's-Edge Manual, to apply the federal source rules an item of gross income must first be classified by type. Once identified by type, then the rules governing the assignment of a particular type of receipt to a particular location are applied to determine the income source. The IRC contains rules for six major classes of income. The classes of income and the general rule for sourcing each class of income are as follows:

- Interest income – sourced to the residence of the debtor.
- Dividend income – sourced to the country in which the payer is incorporated.
- Personal services income - sourced to the location where the services were performed.
- Rents and royalties - sourced at the location where the underlying property is used or usable.
- Income from the disposition of real property sourced where the property is located.
- Income from the disposition of personal property - sourced at the residence of the seller.

There are many exceptions to these general rules. The source rules for each of the above types of income is discussed in detail below. IRC Sections 861-863 are not intended to identify every conceivable type of income.[1] When an item of income is not classified within the statutory scheme or the regulation, courts have sourced the item by comparison and analogy with classes of income specified within the statutes.[2] To determine which class of income an item falls within or may be analogized with, you must look to the substance of the transaction.[3]

b. Interest

Interest represents amount paid for the use of money. For purposes of the U.S. sourcing rules, interest remains broadly defined in IRC Section 1232(b)(1). A general definition of what constitutes interest can also be found in TreasRegs. Section 1.61-7.

1. General Rule

The source rules for interest income are set forth in IRC Sections 861(a)(1) and 862(a)(1). The general rule provides that interest from the United States or District of Columbia, and interest on bonds, notes, or other interest-bearing obligations of U.S. corporation or noncorporate residents are U.S.-source income.[4] The regulations provide that interest from any agency or instrumentality of the U.S. (other than a U.S. possession), any state or political subdivision or such state also constitutes U.S. source income.[5]

Simply stated, the source of interest income is generally the place where the person obligated to pay the debt resides.[6] The method of making payments, or the location of where the interest is paid, is irrelevant.[7] The courts have similarly held that the place of payment of the interest or the physical location of the securities is irrelevant for purposes of determining the source of interest.[8] In A.C. Monk & Co. vs. Commissioner,[9] the taxpayer, a U.S. corporation, hired a Chinese national to act as its sales agent in China. As part of the employment agreement, the salesman was required to give the taxpayer a $15,000 security deposit since he would be handling the finances for the firm in China. The moneys were deposited in the taxpayer's account in a Shanghai bank, and the salesman was paid interest on the deposit out of the Shanghai account. The issue was whether the interest paid by the taxpayer to the salesman on the security deposit constituted U.S.-source income to the salesman, thereby requiring the taxpayer to have withheld taxes from the payments. The taxpayer argued that China was the source of the interest payments since proceeds from the sale of the taxpayer's products in China were deposited in the Shanghai account and business expenses, including the interest payments to the salesman, were paid from the Shanghai account. The court held that the source of the interest was the U.S., the residence of the obligor, since that was where the right to payment arose. This rule raises a number of problems, including

defining interest, determining the residence of the obligor, and identifying the true obligor.

Although IRC Section 861(a)(1) refers to "interest on bonds, notes, and other interest bearing obligations," it is well settled that the language includes all agreements to make interest payments, whether written or oral. The Supreme Court held in Helvering v. Stockholm's Enskilda Bank[10] that the words "other interest-bearing obligations" were not limited to a written interest-bearing obligation similar to a bond or a note, and that interest received on a U.S. tax refund was therefore U.S.-source income. The courts have similarly held that interest received on deposits with a U.S. resident are U.S.-source income.[11] In InverWorld, Inc., et al. V. Commissioner of Internal Revenue,[12] the court had to determine whether the taxpayer was the true obligor of the debt in order to determine whether the taxpayer was obligated to withhold tax from the interest payments to its clients. The court determined, consistent with the finding in Smith Est. v. Commissioner,[13] that the taxpayer was providing a service to its clients by pooling excess investment funds which generated interest income. Accordingly, since the taxpayer did not have an economic interest in the pooled investments, the taxpayer was not obligated to withhold tax on the payments to its clients.

The source of interest income depends on the residence (or place of incorporation) of the debtor. Accordingly, it is necessary to determine both the identity of the true obligor of the debt instrument, and the residence of the debtor. As discussed in InverWorld, Inc., et al,[14] this is a facts and circumstance question requiring scrutiny of the underlying transactions and the debt instrument. Furthermore, if interest on the obligation of a U.S. resident is paid by a nonresident acting in the nonresident's capacity as guarantor of the obligation of the resident, the interest will be treated as income from sources within the U.S. since the U.S. resident is the true obligor.[15]

2. Exceptions To The General Rule

There are two major exceptions to the general rule that the source of interest income is the residence of the debtor.

A. Interest income received from a domestic corporation (or a resident alien individual) is treated as foreign-source income to the payee if at least 80

percent of the payer's gross income from all sources for a specified testing period is active foreign business income.[16] (Such corporations are referred to as "80-20" corporations. Note that California uses the same term. However, for California purposes, an "80-20" corporation is a corporation which has at least 80 percent of its apportionment factors outside the U.S. The federal term "80-20" corporation has no significance for California purposes.)Active foreign business income is defined as gross income from foreign sources which is attributable to the active conduct of a trade or business in a foreign corporation or a possession of the United States.[17] The testing period is the three-year period ending with the close of the taxable year immediately preceding the payment. If the corporation has no gross income for any part of the three year period, the testing period is the taxable year in which the interest payment is made.[18] Interest paid by an 80-20 corporation to a related person is treated as foreign-source income if it meets the active business test, but only to the extent of the ratio of gross income from foreign sources for the test period to total gross income for the test period.[19] For example, if the 80-20 corporation's foreign-source gross income for the test period represents 85 percent of its total gross income for the test period, 85 percent of the interest paid by it to a related person will be treated as foreign-source income. If the interest is paid to an unrelated person, the entire amount will be treated as foreign-source income. If the payer fails to have at least 80 percent of its income treated as foreign business income, even if it is only by one percent, then all of the interest payments will be considered U.S.-source income.[20] A related person is defined as any individual, partnership, trust, estate, or corporation which controls or is controlled by the 80-20 corporation or is controlled by the same person or persons which control the 80-20 corporation. Control is defined as the ownership of 10 percent or more of the voting stock.[21]

B. Interest paid on deposits with a foreign branch of a domestic corporation or partnership is considered foreign-source income if the branch is engaged in the commercial banking business at the time the interest is paid.[22] For this rule to apply, it is not necessary that the domestic corporation or partnership carry on a banking business in the U.S.[23] Alternatively, interest paid by a foreign branch of a domestic corporation or partnership which is not engaged in the banking business constitutes U.S.-source income.

A discussion of the less common exceptions to the general rule for sourcing interest income can be found in TreasRegs. Section 1.861-2(b). However, many

of the less common exceptions, such as the exceptions for insurance companies, would not apply for California purposes.

c. Dividends

Dividends represent a distribution of assets to stockholders. To qualify as "dividend income" the distribution cannot exceed the total of accumulated and current-year earnings and profits. Distributions of assets in excess of earnings and profits are treated as a return of capital with any excess being treated as capital gain income. Additional information on what constitutes a dividend can be found in IRC Section 316 and the regulations thereunder,[24] and in TreasRegs. Section 1.61-9.

Two factors are considered in determining the source of dividend income. The country in which the payer is incorporated and the source of the payer's gross income. Dividends received from a domestic corporation generally constitute U.S.-source income.[25] However, dividends received from an IRC Section 936 corporation, which is also domestically incorporated, are considered foreign-source income.[26] Dividends received from a DISC are treated as foreign-source income to the extent the are attributable to qualified export receipts.[27] Dividends paid by a FSC are considered foreign-source income under the general rule.

If the dividend is received from a foreign corporation, the taxpayer generally applies one of two rules.[28]

1) None of the dividends paid by a foreign corporation are considered U.S. - source income if less than 25 percent of the corporation's gross income from all sources for the three-year period prior to the dividend declaration is from income effectively connected with the corporation's conduct of a U.S. trade or business. This test is done on an entity-by-entity basis.[29]

2) If 25 percent or more of the corporation's gross income for the three-year period is U.S.-source income effectively connected with the corporation's U.S. trade or business activities, then a portion of the dividend is deemed to be from U.S. sources. The deemed U.S.-source dividend is equal to the proportion of the corporation's income effectively connected with the U.S. trade or business to gross income from all sources.

Example 1:

Truffles A.G., a West German corporation engaged in the worldwide distribution of chocolate candies, was formed in 1988 and is owned by a West German citizen. Truffles has operated a chain of candy stores in the U.S. since 1991. On December 31, 1996, Truffles A.G. declared a dividend of $500,000. During the three years immediately preceding the year in which the dividend was declared (i.e., 1993, 1994, and 1995), Truffles earned income of $400,000 from U.S. sources, and $1,200,000 from foreign sources. Of the $500,000 dividend paid to the West German citizen, 25 percent (400,000/1,600,000), or $125,000, is deemed to be U.S.-source income to Truffles' West German shareholder.

d. Personal Services

Generally, compensation for labor or personal services is sourced at the place where the services are performed.[30] The place or time of payment, the location of the employer, the nationality of the employee, or the place where the contract was made are irrelevant in determining the source of the compensation.[31]

If services are performed partly within and partly without the U.S. and a specific amount is paid for the services performed within the U.S., then the amount specified as paid for the services performed in the U.S. is considered U.S.-source income. If a lump sum payment is made for services performed partly within and partly without the U.S., and there is no specific agreement as to the amount of pay attributable to the U.S., then a method that most correctly reflects the proper source of income based on the facts and circumstances of the particular case should be used to source the income from personal services. Any method of allocation is acceptable as long as it does not distort income. Allocation is most frequently based on a time basis, but other methods of allocation are acceptable based upon the facts an circumstances of the particular case.[32]

Activities do not have to be performed by an individual in order to be considered income from personal services. A corporation or other entity is considered capable of rendering personal services through the actions of its employees.[33]

Example 2:

Alpha, a West German corporation, is hired by Beta, a U.S. firm, to develop a custom engineering software program for use in Beta's business in the U.S. Alpha is paid a fee of $1,000,000 for its services over a period of eight months. Alpha's computer programmers devoted approximately 66 percent of their time in Germany developing the software program, and 33 percent of their time in the U.S. installing the program and providing the necessary technical support and training for Beta. There was no specific agreement as to the amount paid for services performed within the U.S.

If service income is allocated based on time, 66 percent, or $660,000, would be considered foreign-source income. However, if Alpha can demonstrate that the services rendered in Germany were of greater value than those rendered in the

U.S., more income could be allocated to Germany than would be allocated on a straight time basis.

Services rendered by a taxpayer's agent are deemed to be rendered by the taxpayer in the place where the agent renders the services. The courts have held it is the character of the services that determines whether they are personal services and not the fact that the taxpayer performs them in person.[34] In Le Beau Tours Inter-America, Inc.,[35] the taxpayer acted as a wholesale travel agent who arranged and marketed Latin American package tours through retail travel agents in the U.S. The American customer would pay Le Beau the full retail price for the hotel and tour services and Le Beau would then remit the amount less a commission to the local hotel or tour operator who actually provided the services. Le Beau maintained its U.S. office in its parent company's office facility in New York and its bookkeeping and other clerical work was performed by employees of the parent company. Le Beau paid its parent an annual lump sum for these services.

Le Beau contended that it received its income by making arrangements for hotel accommodations and ground services for overseas travelers. Thus it asserted all its income was from foreign sources. However, the court held that Le Beau did not provide these services—it merely purchased them from foreign operators for its American clients. Le Beau's compensation was derived from facilitating and encouraging American travel, and its services consisted of planning, organizing and promoting its tours. To the extent these services were performed within the U.S., the income derived therefrom was income from U.S. sources. The court held that it was irrelevant whether these services were performed by its own employees or by employees of its parent corporation. Thus, the value of all time spent by personnel of the parent company in performing services, such as administrative and clerical work in connection with the Latin American tours, was considered in determining the amount of income derived from U.S. sources.

An exception to the general rule that the source of compensation is the place where services are performed is provided in limited situations if a nonresident alien individual receives compensation for services performed in the U.S. and the amount received does not exceed $3,000.[36] This rule has no significance for California purposes since it applies to individuals.

Special rules must be applied for purposes of classifying transactions involving computer programs, effective for transactions occurring pursuant to contracts

entered into on or after December 1, 1998.[37] A computer program is defined as a set of statements or instructions to be used directly or indirectly in a computer to bring about a certain result, including any media, user manuals, documentation, data base or similar item if the media, user manuals, documentation, data base or similar item is incidental to the operation of the computer program.[38]

In general, one category for these transactions involving the transfer of a computer program is the provision of services for the development or modification of the computer program.[39] The determination of whether a transaction involving a newly developed or modified computer program is treated as the provision of personal services is based on all the facts and circumstances of the transaction, including, as appropriate, the intent of the parties (as evidenced by their agreement and conduct) as to which party is to own the copyright rights in the computer program and how the risks of loss are allocated between the parties.[40] See the following Section 8.4(e), Water's-Edge Manual, for a more detailed discussion on this recently finalized regulation.

e. Rents & Royalties

Income received for the use or privilege of using tangible or intangible property is sourced at the location where the property is used or usable. This rule applies to all types of real and tangible personal property, and to intangible property, including patents, copyrights, secret processes and formulas, goodwill, trademarks, franchises, and other similar property.[41] Payments received with respect to transfers of nonpatentable "know-how" are considered royalties.[42] If the transfer involves a grant of an exclusive license, the transfer may be deemed a sale.[43]

There are two issues associated with payments for the use of property. The first issue is correctly identifying the character of the payment received in connection with the use of the property. The second is identifying the location where the property is being used.

1. Correct Characterization Of Payments

Payments for the use of tangible real or personal property are easily characterized as rent. Similarly, payments for the use of intangible property are usually characterized as royalties. In some situations, however, an issue arises whether the payments involving intangible property represent royalties, compensation for services rendered, or proceeds from the sale of an asset.

The correct characterization of the payment can have significant U.S. tax implications due to the different sourcing rules for royalties, services and the sale of property. In Karrer vs. U.S.,[44] the taxpayer, a nonresident alien, entered into agreements with a Swiss corporation granting it the commercial rights to his inventions. The taxpayer was to be paid a percentage of the profits from the sale of the product. Under Swiss law these were special employment contracts, under the terms of which all patents resulting from the taxpayer's inventions belonged to the Swiss corporation. The Swiss corporation granted its U.S. subsidiary the exclusive right to use the patented process in the U.S. The U.S. company paid a percentage of its sale proceeds directly to the taxpayer.

The taxpayer successfully argued that the payments received from the U.S. company were not royalties for the right to use the taxpayer's intangible assets

(patents) in the U.S., but rather the payments were compensation for services performed outside the U.S. for the Swiss parent. Since the services were performed outside the U.S., they were not taxable in the U.S. If, however, the payments received by the taxpayer had been held by the court to be royalties received for the use of intangible property in the U.S., the income would have been U.S. source income subject to U.S. taxes.

Whether income received is a royalty turns on whether the transferor has retained a substantial right to the transferred property.[45] If the transferor retains any rights in the property being exploited or a continued participation in the transferees business, the payment is a royalty.[46] If the exclusive rights to exploit the intangible property using a particular medium or in a specific location are not retained by the transferor and are transferred for the entire life of the copyright or patent, then the entire payment will be considered either income from personal services or proceeds from the sale of an intangible asset depending on the facts and circumstances.[47]

2. Identifying The Location Where Property Is Used

If the item in question has been characterized as either a rent or royalty payment, then it must be determined whether the property is rented or licensed for use within or without the U.S. The location where the property is rented or licensed for use is the determining factor as to the source of the payments received.[48] The location of use must also be determined by looking to the location of use by the parties to the licensing agreement. In SDI Netherlands B.V.,[49] SDI Bermuda Ltd.(Bermuda), a subsidiary of SDI Ltd., owned the rights to certain commercial systems software. SDI Bermuda licensed the worldwide rights to the software to its affiliate, SDI Netherlands B.V.(BV), who in turned licensed the U.S. rights to its subsidiary, SDI U.S.(US). US made royalty payments to BV which were exempt from withholding tax under the U.S.-Netherlands treaty. BV then made royalty payments to Bermuda out of funds that included amounts received from US. It was IRS' position that the payments by BV to Bermuda were U.S.-source income to the extent royalties paid by BV were out of funds received from US since the amounts received from US were for the use of the license in the United States. The court held that the licensing agreement between BV and Bermuda was separate and distinct from the licensing agreement between US and BV, and although the payments by US to BV constituted U.S.-source income from the use of the intangible property in the United States, the payments by BV to Bermuda

did not. The court found support for its position in that the IRS' position would cause a cascading royalty whereby multiple withholding taxes could be paid on the same royalty payment as it transferred up a chain of licensers.[50]

It is important to note that the situs of the parties involved in the license or rental agreement is irrelevant. If the property is licensed or rented for use outside the U.S., then the amounts received as rents or royalties are not U.S.-source income even if paid by a U.S. company.

In Revenue Ruling 75-483, the IRS held that income received by a U.S. corporation from the bareboat charter hire of a vessel to an unrelated U.S. company, which used the vessel primarily to transport goods from Alaska to various other ports located within the U.S., constituted income within the U.S. even though the vessel traveled, in part, outside U.S. territorial waters. Such income would have been considered income from partially within and partially without the U.S. if the boat vessel was transporting goods between the U.S. and foreign ports.[51] The legal situs of the boat was irrelevant.[52]

Similarly, in Wodehouse vs. Commissioner[53], the Court of Appeals, on remand from the Supreme Court, held that royalty payments made by a U.S. company to a nonresident alien for exclusive book rights in North America was income partly from within and partly from without the U.S. since the North American rights included the rights to Canada. However, when income is generated from both within and without the U.S., the burden is on the taxpayer to prove the amount received for use of the property outside the U.S. If the taxpayer fails to carry that burden, the income will be allocated entirely to the U.S.[54] In this particular case, the contract was silent on the value of the book rights to Canada. Since the taxpayer was unable to prove the value of the Canadian rights, all royalties received by the taxpayer were considered U.S.-source income.

In Molnar v Commissioner,[55] the taxpayer, a nonresident alien, received lump-sum payments for assigning the worldwide rights to certain movies to U.S. companies. Although the income generated by the films was from sources partly within and partly without the U.S., no segregation of the lump-sum payments was made between the rights exercised in the U.S. and those exercised worldwide. Further, the taxpayer was unable to submit any data which could be used as a basis for allocating part of the payments to foreign use. As a result, the entire amount received was treated as U.S.-source income.

Example 3:

Fred, a citizen and resident of a Luxembourg, licenses the worldwide rights to a patent to Widgets B.V., a Netherlands corporation. Widgets B.V. agrees to pay Fred a fixed royalty each year in return for the patent licenses. Widgets B.V. re-licenses the patent to Microwidgets, a U.S. corporation, for use of the patent in the U.S. Widgets B.V. also re-licenses the patent to Macrowidgets, a U.K. corporation, for use of the patent in Europe. Microwidgets and Macrowidgets agree to pay Widgets B.V. royalties based on the number of units produced. Seventy percent of the royalties received by Widgets B.V. are paid by Microwidgets.

The royalties paid by Microwidgets to Widgets B.V. are paid in consideration for the privilege of using a patent in the U.S., and are therefore treated as U.S.-source income subject to U.S. income taxation. However, any payment made by Widgets B.V. to Fred would not be considered U.S. source income even though 70 percent of the royalties received by Widgets B.V. are for the use of a patent in the U.S., provided the two licensing agreements are separate and distinct.[56]

3. Transactions Involving Computer Programs

A computer program is defined as a set of statements or instructions to be used directly or indirectly in a computer to bring about a certain result, including any media, user manuals, documentation, data base or similar item if the media, user manuals, documentation, data base or similar item is incidental to the operation of the computer program.[57] Special rules must be applied for purposes of classifying transactions involving computer programs, effective for transactions occurring pursuant to contracts entered into on or after December 1, 1998.[58]

In general, a transaction involving the transfer of a computer program or the services or know-how with respect to a computer program is treated as being solely one of the following[59]:

- A transfer of a copyright right in the computer program;
- A transfer of a copy of the computer program (a copyrighted article);

- The provision of services for the development or modification of the computer program; or

- The provision of know-how relating to computer programming techniques.

Any transaction, which consists of more than one of these above transactions, will be treated as separate transactions, applying the appropriate provisions to each such transaction. However, any transaction that is de minimis, taking into account the overall transaction and the surrounding facts and circumstances, will not be treated as a separate transaction.[60]

A transfer can be classified as involving copyright rights or copyrighted articles. A transfer is classified as a transfer of a copyright right if, as a result of the transaction, a person acquires any one or more of the following rights[61]:

- The right to make copies of the computer program for purposes of distribution to the public by sale or other transfer of ownership, or by rental, lease or lending;

- The right to prepare derivative computer programs based upon the copyrighted computer program;

- The right to make a public performance of the computer program; or

- The right to publicly display the computer program.

A transfer that is classified as a copyright right is treated as either a sale or exchange of an intangible, or a license generating royalty income.[62] The determination of whether a transfer of a copyright right is a sale or exchange of property is made on the basis of whether, taking into account all facts and circumstances, there has been a transfer of all substantial rights in the copyright. A transaction that does not constitute a sale or exchange because not all substantial rights have been transferred will be classified as a license generating royalty income.[63]

If a corporation acquires a copy of a computer program but does not acquire more than a de minimis grant of the above described rights, and if the transaction does not involve more than a de minimis provision of services or of know-how, then the transfer of the computer program copy is classified as a transfer of a

copyrighted article. A copyrighted article includes a copy of a computer program from which the work can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device. The copy of the program may be fixed in the magnetic medium of a floppy disk, or in the main memory or hard drive of a computer, or in any other medium.[64]

A transfer that is classified as a copyrighted article is treated as either a sale or exchange of tangible personal property or a lease generating rental income.[65] The determination of whether a transfer of a copyrighted article is a sale or exchange is made on the basis of whether, taking into account all facts and circumstances, the benefits and burdens of ownership have been transferred. A transaction that does not constitute a sale or exchange because insufficient benefits and burdens of ownership of the copyrighted article have been transferred, such that a person other than the transferee is properly treated as the owner of the copyrighted article, will be classified as a lease generating rental income.[66]

The determination of whether a transaction involving a newly developed or modified computer program is treated as personal services is discussed in the prior Section 8.4(d), Water's-Edge Manual.

The provision of information with respect to a computer program will be treated as the provision of know-how for purposes of this section only if the information is[67]:

- Information relating to computer programming techniques;
- Furnished under conditions preventing unauthorized disclosure, specifically contracted for between the parties; and
- Considered property subject to trade secret protection.

In determining how a transaction involving a computer program is classified, all the facts and circumstances must be considered. The form adopted by the parties to the transaction and the classification of the transaction under copyright law will not effect the determination.[68] In addition, these rules apply regardless of the physical, electronic, or other medium used to effectuate a transfer of a computer program.[69] Once these transactions are classified, e.g., personal services, rents or royalties, sale of personal property, etc., the same sourcing

rules that apply for these categories will apply to these computer program transactions. For examples classifying these types of transactions, see Treasury Regulation §1.861-18(h).

f. Dispositions Of Real Property Interests

Gains, profits, and income from the disposition of a United States real property interest (USRPI), as defined in IRC Section 897(c), is U.S.-source income.[70] A disposition is defined as any transfer, including liquidations and contributions of capital.[71] IRC Section 862(a)(5) provides that gains, profits, and income from the sale or exchange of real property located without the U.S. is foreign source income.

Thus income from the disposition of a real property interest is sourced to the location of the underlying property. USRPIs for these purposes include both direct and indirect ownership of real property. For example, the stock of a domestic corporation whose assets are predominantly U.S. real property is a USRPI.[72]

1. U.S. Real Property Interest

The term "U.S. real property interest" (USRPI) is defined as follows:

1) Any interest, other than an interest solely as a creditor, in real property located in the U.S. or U.S. Virgin Islands.[73] An "interest" in real property includes fee ownership, leaseholds, options to acquire real property, and options to acquired leaseholds of real property.[74]
2) Any interest in a partnership, estate, or trust to the extent of the USRPI held by such entity.[75]
3) Any interest, other than solely as a creditor, in any domestic corporation unless the taxpayer establishes that such corporation did not meet the definition of a U.S. real property holding corporation (USRPHC) at any time during the shorter of:
   a) The five year period ending on the date of disposition of the interest, or
   b) The period after June 18, 1980, during which the taxpayer held the interest.[76]
4) Three categories of domestic corporations are specifically excluded from the definition of a USRPHC:[77]
   a) An interest in a domestically controlled real estate investment trust (REIT).[78]

b) An interest in a publicly trade corporation, if the taxpayer holds or has historically held (directly or indirectly) no more than 5 percent of the traded stock of the corporation. An interest in a publicly traded partnership or trust is treated as a publicly traded corporation.[79]
c) An interest in a corporation which has disposed of its USRPI in a transaction in which the full amount of the gain was recognized.[80]

The net effect of the above rules is that a domestic corporation which meets the USRPHC test (discussed below) at any time remains a USRPHC for the ensuing five years unless it disposes of its USRPI in a transaction in which the full amount of the gain is recognized for tax purposes. The IRC also provides that if a domestic corporation holds USRPI that ceases to meet the USRPI standard, such corporation will not be considered a USRPHC.[81]

Example 4:

The sole asset of Corporation A, a U.S. incorporated holding company, is stock in Corporation B, a U.S. Corporation that owns U.S. real estate. Corporation A and Corporation B are both considered a USRPHC. If corporation B disposes of its real estate in a fully taxable transaction, it ceases to be a USRPHC. Thus, the stock of Corporation B will cease to be considered a USRPI to Corporation A, and Corporation A will also cease to be considered a USRPHC.

2. Real Property Defined

The term real property includes three categories of property: land and unsevered natural products of the land; improvements; and certain tangible personal property associated with the use of the real property.[82] It should be noted that crops and timber cease to be real property at the time they are severed from the land. Ores, minerals and other natural deposits cease to be real property when they are extracted from the ground.[83] An improvement is defined as a building and its structural components, and any other inherently permanent structure that is affixed to real property.[84] Finally, personal property is considered associated with the use of a real property interest only if both the personal property and the real property are held by the same person or by a related person.

Personal property is associated with the use of real property only if it falls into one of the following four categories:[85]

A. Property Used In Mining, Farming, And Forestry

Property used to exploit unsevered natural products from the land is treated as associated personal property. Examples of such associated personal property include mining equipment, planting and harvesting equipment, and draft animals. Equipment used to process, handle, or transport products after they are severed from the land is not considered associated personal property.[86]

B. Property Used To Improve Real Property

Property is associated with the use of real property if it is predominantly used to construct real property. Examples include earth moving equipment, tractors, bulldozers, cement-mixers, and other kinds of construction equipment.[87]

C. Property Used In The Operation Of Lodging Facilities

Property is associated with the use of real property if it is predominantly used in connection with the operation of a lodging facility. A lodging facility is any structure used to provide, at a charge, living and/or sleeping accommodations. Examples include an apartment house, hotel, dormitory, or residence.[88]

Personal property that is used in connection with the operation of a lodging facility includes property located in the living quarters, such as beds, refrigerators, and other equipment, as well as property used in the common areas of the facility, such as lobby furniture and laundry equipment. The term does not include personal property in areas used by customers of the facility and by the public at large, such a s dining rooms and drug stores.

The term "lodging facility" does not include:

- a personal residence occupied solely by its owner;
- a facility used primarily as a means of transportation, such as an airplane, ship or railroad car; or
- a medical facility or convalescent home.

D. Property Used In The Rental Of Furnished Office Or Similar Workspace

Personal property is associated with the use of real property if it is predominantly used by a lessor to provide furnished office or other workspace to lessees.

Examples include office furniture and any other equipment furnished by the lessor.[89]

When associated personal property is sold it is generally considered a disposition of USRPI. However, the Treasury Regulations provide that an item of associated personal property will lose its status as USRPI if:

- the personal property is disposed of more than a year before the real property with which it is associated is sold;
- the personal property is disposed of more than a year after the real property with which it is associated is sold; or
- the personal property and the real property are sold to buyers that are not related to the seller or to each other.[90]

3. U.S. Real Property Holding Corporation

A domestic corporation is considered a USRPHC if the fair market value (FMV) of its USRPI on any applicable "determination date" equals 50 percent or more of the FMV of its total assets.[91] The determination dates for testing whether a corporation is a USRPHC are generally the last day of the corporation's tax year or any date on which it acquires or disposes of real property or a real property interest.[92]

The regulations provide limitations with regard to the acquisitions and dispositions of property so that commonly occurring or de minimis transactions will not trigger a re-determination. For example, dispositions of inventory, disbursements of cash to meet regular operating needs or dispositions of business assets, not in excess of specified limitation amounts, will not trigger a re-determination.[93] FMV is defined as gross value less purchase money mortgage against the property.[94] The regulations provide an alternative to the FMV test. If the book value of the USRPI of a corporation is 25 percent or less of the book value of the total assets, it is presumed the corporation is not a USRPH.[95] This presumption is rebuttable.[96]

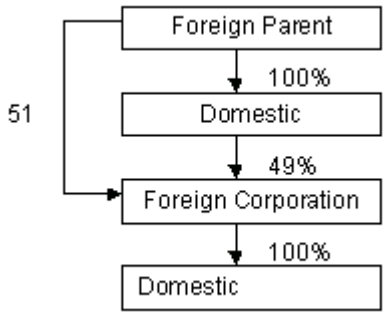
For purposes of the 50 percent asset test, total assets include the following:[97]

A. U.S. real property interests that are held directly by the corporation, including stock of a corporation which itself qualifies as a USRPHC. Only for purposes

of detmining whether a domestic corporation is a USRPHC, an interest in a foreign corporation is treated as a USRPI if the foreign corporation meets the USRPHC asset test.

Example 5:

A foreign parent corporation owns 100 percent of Domestic Corporation A and 51 percent of Foreign Corporation F. Domestic Corporation A owns 49 percent of Foreign Corporation F. Foreign Corporation F owns Domestic Corporation B which owns U.S. real property. The ownership structure is illustrated by the following diagram:



For purposes of determining if Foreign Corporation A is a USRPHC, its interest in the stock of Foreign Corporation F is treated as a USRPI since Foreign Corporation F meets the USRPHC asset test (e.g., 50 percent or more of the FMV of Foreign Corporation F's total assets are considered USRPI).[98] Note, however, that Foreign Corporation F is not a USRPHC. The foreign parent's interest in the stock of Foreign Corporation F is not a USRPI, although its interest in the stock of Domestic Corporation A is a USRPI. Accordingly, the foreign parent could sell the stock in Foreign Corporation F without generating U.S. source taxable income under IRC Sections 897 and 861(a)(5). However, if the foreign parent sold the stock of Domestic Corporation A, it would generate U.S.-source income from the sale of a USRPI.

If the above rule regarding foreign corporations was not in effect, then Domestic Corporation A would not meet the USRPHC asset test, and its stock would not be a USRPI to the foreign shareholder.

B. Interests in real property located outside the U.S. that are held directly by the corporation.[99]
C. Other assets which are used or held for use in a trade or business that are held directly by the corporation.[100] Assets used or held for use in a trade or business include both tangible property (such as inventory and depreciable property) and intangible property (such as goodwill, patents, cash, securities and receivables).[101] For these purposes, an asset is considered held for use in a trade or business only if the asset is held to meet the present needs of the business and not its anticipated future needs.[102]
D. A proportionate share of assets held through a partnership, trust, or estate to the extent of the corporation's interest in such entity. The proportionate ownership rule applies successively upward through a chain of ownership.[103]
E. A proportionate share of assets held by a lower-tier domestic or foreign corporation, if the corporation holds a controlling interest, defined as ownership of 50 percent or more of the FMV of all classes of stock. The rule looks through any number of controlled tiers.[104]

For example, if a second-tier corporation owns a controlling interest in a third-tier corporation, the look-through rule is applied first to determine the portion of the assets of the third corporation considered to be held by the second corporation. The rule is then applied to determine the portion of the assets directly held and considered to be held by the second corporation that are considered to be held by the first corporation.

When the look-through rules apply, the interest in the entity is disregarded and the proportionate share of the entities assets are included in the corporation's own list of assets.[105]

The following questions will help you to better understand the USRPI rules:

Question 1: Omega Corporation owns Beta Corporation, a California corporation, which in turn owns and manages an office building located in Los Angeles. Assuming Beta Corporation has no other significant assets, is the stock of Beta Corporation considered a USRPI of Omega Corporation?

Answer: Yes, since over 50% of Beta's assets are considered a USRPI.

Question 2: Omega Corporation owns all of the stock of Beta Corporation. Beta Corporation, a California corporation, is engaged in the business of importing and

selling auto parts manufactured in Japan. Beta Corporation owns an office building from which it conducts its U.S. business. In 1991, the value of the building represents 45% of Beta's total assets. The value of the office building increases so that by December 31, 1993, the building represents 55% of Beta Corporation's total assets. Beta Corporation sold the office building on January 12, 1998, and reported the realized gain during 1998. Is Beta Corporation a USRPHC in 1991? In 1993? In 1997? In 1998?

Answer: In 1991-no. In 1993-no. In 1997-yes. In 1998-no, as of the day after the sale of its USRPI in a transaction which recognized the gain on sale of the property. Beta becomes a USRPHC effective 12/31/93, the "determination date", and would continue to be considered a USRPHC for the ensuing 5 years, or until it sold its USRPI in a fully taxable transaction. In this situation, it ceased to be considered a USRPHC on January 12, 1998, when it sold its USRPI, the building, in a fully taxable transaction.

Question 3: Omega Corporation creates Corporation X, a Netherlands Antilles corporation. Corporation X owns all of the stock of Beta Corporation. Beta Corporation's only asset is U.S. real estate located in Nevada. Is Omega Corporation's interest in Corporation X a USRPI? Is Corporation X's interest in Beta Corporation a USRPI?

Answer: Omega's interest in Corporation X is not a USRPI. Only a domestic corporation can be classified as a USRPHC. Corporation X's interest in Beta does, however, qualify as a USRPI. An interest in a foreign corporation is treated as a USRPI if the foreign corporation meets the USRPHC asset test only for purposes of determining if the lower tier domestic corporation is a USRPHC.

Question 4: On December 31, 1996, the FMV of the assets of Omega Corporation were as follows:

Cash	$ 150,000
Marketable Securities	150,000
Inventory	400,000
Accounts Receivable	350,000
Furniture and Fixtures	25,000
Land	200,000
Building (net of mortgage)	800,000

Total Assets 2,075,000

(a) Assume all of the assets are held for use in Omega Corporation's business. The furniture and fixtures are not associated with the use of the real property. Is Omega Corporation a USRPHC?
(b) Assume the marketable securities are being held for future expansion into a new business. Is Omega Corporation considered a USRPHC?

Answer:

(a) No. Less than 50% of Omega's assets are USRPI (i.e., $1,000,000/$2,075,000 = 48%)
(b) Yes. Since the marketable securities are not held for a current business need, they are disregarded. If this category is disregarded, total assets equals $1,925,000, of which real property equals 51.9% ($1,000,000/$1,925,000). Omega is a USRPHC.

g. Sale Or Exchange Of Personal Property

Subject to many important exceptions, the general rule for personal property is that income from the sale, exchange or other disposition of such property is sourced to the residence of the seller.[106] If the seller of the personal property is a U.S. resident, the income from the sale of the property is generally sourced to the U.S.[107] If the seller is a nonresident, the income from the sale is generally sourced outside the U.S.[108] (Refer to Section 8.4(e), Water's-Edge Manual, for a discussion of transactions involving computer programs that may be classified as the sale or exchange of personal property.

Although the seller's residence is the general rule for sourcing sales of personal property, there are few situations where the general rule actually applies. Most income derived from the sale of personal property is sourced according to one of the exceptions to the general rule. The principal types of property excepted from the general rule are inventory,[109] depreciable property,[110] and intangible property.[111] The exceptions to the residence of the seller rule are discussed in detail below.

1. Exception-Sale Or Exchange Of Inventory Property

Income derived from the sale of inventory is generally considered derived entirely in the country in which the property is sold.[112] This rule does not apply to inventory purchased within a possession and sold within the U.S.[113] Nor does it apply to inventory produced by the taxpayer within the U.S. and sold outside the U.S., or to inventory produced by the taxpayer outside the U.S. and sold within the U.S.(as opposed to inventory purchased by the taxpayer for resale).[114] Income from these types of transactions is treated as being derived partly from within and partly from without the U.S.[115] The rules regarding transactions treated as being derived from partly within and partly without the U.S. are discussed in Part 1B of Section 8.4(g), Water's-Edge Manual.

A gain from insurance proceeds received with respect to goods lost in transit is deemed to be sourced to the place from which the goods were shipped. Thus, if the goods are shipped from London to New York but are lost at sea, the source of the insurance proceeds is London, even if the ship is only a few hours from the point of destination.[116]

A. Inventory-The General Rule

As stated above, income derived from the sale of inventory is generally sourced to the country in which the property is sold. Thus, if a taxpayer purchases inventory outside the U.S. and sells it within the U.S., the profit is U.S.-source income. Similarly, if a taxpayer purchases inventory within the U.S. and sells it outside the U.S., the profit is considered foreign-source income. For purposes of this discussion, inventory includes stock in trade of the taxpayer or other property which would properly be included in the inventory of the taxpayer if on hand at the end of the taxable year, or property held by the taxpayer is primarily for sale to customers in the ordinary course of his trade or business.[117]

An exception to the above rule is provided for sales outside the U.S. by a nonresident which are attributable to its U.S. office or fixed place of business. See the discussion in Part 4 of Section 8.4(g), Water's-Edge Manual for more information on this exception.

The Treasury Regulations provide that a sale of inventory occurs at the time and place where the seller's rights, title and interest in the property are transferred to the buyer. Where bare legal title is retained by the seller, the sale is deemed to occur when the benefits and burdens of ownership pass to the buyer. This rule is referred to as the "passage of title" rule. Note that if a sales transaction is arranged in a particular manner for the primary purpose of tax avoidance, the passage of title rule does not apply. In such cases the sale is treated as being concluded at the place where the substance of the sale occurred, as determined by the facts and circumstances of the particular case. All factors of the transaction, such as the place of negotiations and execution of the agreement, the location of the property, place of payment will be considered in making this determination.[118]

Case law has established that the time and place when title passes depends on the intention of the parties. Where the intention of the parties is not clearly stated, the courts have determined their intention by reference to the facts and circumstances surrounding the sale. One important fact considered by the courts in determining the place where title passed is the terms used in the trade contracts entered into by the parties.[119] The most common terms used in trade contracts are FOB, FAS, CIF, and C&F.

FOB and FAS

FOB stands for "Free on Board" and FAS stands for "Free Alongside". When goods are shipped FOB or FAS, the seller delivers the goods to a designated point and the buyer pays the cost of delivery from the point the goods are delivered. The designated point can be the point of shipment, the point of destination, or any point in between. Title is presumed to pass from the seller to the buyer in the designated FOB or FAS location.

CIF and C&F

CIF stands for "Cost, Insurance, and Freight." When goods are shipped CIF, the seller places the goods aboard a common carrier, prepays the freight, procures proper insurance on the goods, delivers the bill of lading to the buyer, and collects a lump sum price which includes the basic cost of the goods as well as the freight and insurance costs paid by the seller. Under such contracts, title to the goods is presumed to pass from the buyer to the seller at the point of shipment, provided the seller has complied with the requirements set forth in the contract.

C&F stands for "Cost and Freight". The primary difference between CIF and C&F contracts are that the seller does not buy the insurance for the buyer under a C&F contract. Other than that, C&F and CIF contracts create the same presumption as to passage of title. Title to the goods is presumed to pass from the buyer to the seller at the point of shipment, provided the seller has complied with the requirements set forth in the contract.

Case Law

A good analysis of the passage of title rule is found in Ronrico Corporation vs. Commissioner.[120] Ronrico, a Puerto Rican corporation engaged in the manufacture of rum, entered into an exclusive marketing agreement with a U.S. distributor. Upon receiving an order from the U.S. distributor, Ronrico delivered the packaged goods to the common carrier designated by the distributor, prepaid the freight, and secured insurance covering the shipment. Ronrico then prepared an invoice showing prices which covered insurance and freight and submitted the invoice, a copy of the bill of lading, and the insurance policy to the distributor. Unlike the typical CIF transaction, the bills of lading and insurance policies were

made out in the name of Ronrico, thus leaving title to the goods with Ronrico until after shipment. Strictly considered, therefore, title did not pass until delivery of the bills of lading to the buyer in the U.S.

The court held that "the final acts essential to the sale, the shipment of the goods and the forwarding of the documents, took place in Puerto Rico". It was there that the sale was made. The court found that when this type of dealing is followed only for the purpose of giving security to the seller, it does not prevent the passage of beneficial ownership and risk of loss to the buyer at the point of shipment.

The Tax Court's decision in Liggett Group Inc. vs. Commissioner[121] also provides an interesting analysis of the passage of title rule. In Liggett Group Inc., the court held that sales from a U.K. liquor manufacturer to a U.S. distributor, followed by the immediate resale by the distributor to its U.S. customers, produced foreign-source income to the distributor. The distributor never had physical possession of the product it sold to the U.S. customers. Instead, the manufacturer shipped goods directly to the U.S. customer FOB a designated ship located in the U.K. The U.S. customer bore the freight charges as well as any risk of loss or damage to the product during transit under the shipping contract. The U.K. manufacturer sent its invoice for the goods to the distributor and the distributor acquired and disposed of title to the goods at issue only momentarily. However, the court held that the transaction was sufficient to transfer rights, title, and interest to the goods. Thus, it constituted a sale in the British Isles. Although the IRS did not appeal this decision, they did issue an Action on Decision indicating that they did not acquiesce to the decision.[122]

B. Income From Partly Within And Partly Without The U.S.

i. Income Years Beginning On Or After November 13, 1998

The regulations describe income derived from sales partly from sources within the U.S. and partly from sources within a possession of the U.S. as "Section 863 Sales". To determine the source of income derived from Section 863 Sales, the sales are first broken down into two categories. Income from the sale of inventory produced (in whole or in part) by the taxpayer within the U.S. and sold within a possession, or, produced (in whole or in part) by the taxpayer in a possession and sold within the U.S. is referred to as Possession Production

Sales. Income from the purchase of personal property within a possession and sold within the U.S. is referred to as Possession Purchase Sales.[123] The purpose of these rules is to apportion income derived from the production of goods to the country of production and income derived from the sale of those goods to the country of sale.

These rules do not apply to determine the source of a taxpayer's gross income derived from a sale of inventory purchased from a possession corporation if the taxpayer's income from those sales is taken into account to determine the IRC §936 benefits for the possession corporation. (For rules to be applied to determine the source of such income, see Treasury Regulation §1.936- 6(a)(5) Q&A 7a and §1.936-6(b)(1) Q&A 13.)[124]

Possession Production Sales

The IRC provides that the gross income realized from the above transactions is first reduced by the direct and indirect expenses, losses, and other deductions to arrive at the entire taxable income.[125] The Treasury Regulations set forth three alternative methods for determining the portion of the entire taxable income that is to be treated as U.S.-source and foreign-source income. For income years beginning on or after November 13, 1998, the methods are[126] :

Possession 50/50 method;
Independent factory price (IFP) method; or
Books and records method.

The possession 50/50 method is the method used to compute income within and without the U.S. for Possession Production Sales, unless the taxpayer elects to use either the IFP method or the books and records method.[127] Under the possession 50/50 method, once the amount of gross Possession Production Sales is determined, the gross sales are sourced 50 percent to the location of production and 50 percent to the location of the sales activities.[128]

The location of the production activity is determined by reference to the location of tangible and intangible assets owned by the taxpayer used directly to produce inventory, which are considered to be Possession Production Sales when sold. Assets not directly used to produce inventory, including accounts receivable, marketing intangibles, and cash, are not considered in the computation.[129] Production assets are valued at average of beginning and ending adjusted

basis.[130] If all of the production assets are in one location, then the entire 50 percent of the gross Possession Production Sales are sourced to that location. If the production assets are located within and without the U.S., then foreign-source gross Possession Production Sales are determined by multiplying the 50 percent production gross sales by the ratio of production assets that are located outside the U.S. to total production assets. The remaining gross production receipts are sourced to the U.S.[131]

The IFP method can only be used by a taxpayer to compute income within and without the U.S. if an IFP can be fairly established. (This is effectively a comparable uncontrolled price method.) A taxpayer that regularly sells part of its output to wholly independent distributors or other selling concerns in such a way as to reasonably reflect the income earned from production activities would be able to establish an IFP. A taxpayer that does not sell to independent distributors would not be able to use the IFP method because the taxpayer could not establish an IFP.[132] If the taxpayer elects the IFP method, the amount of gross sales price equal to the IFP is treated as attributable to production activity. The excess of the gross sales price over the IFP is treated as attributable to sales activity.[133]

A taxpayer may elect to allocate gross income using the books and records method, but only if it has received in advance the permission of the District Director having audit responsibility over its return.[134] If the taxpayer elects this method, sales are attributable to production and sales activities based on its books and records. The taxpayer must establish to the satisfaction of the District Director that the taxpayer, in good faith and unaffected by considerations of tax liability, will regularly maintain its books and records to clearly reflect its transactions.[135]

An election to use either method is made by using that method to compute the taxpayer's U.S.-source income on a timely filed original return. Once a method has been used, that method must be used in later taxable years unless the Commissioner consents to a change. Permission to change methods from one year to another year will be granted unless the change would result in a substantial distortion of the source of the taxpayer's income.[136]

Possession Purchase Sales

The IRC provides that the gross income realized from the above transactions is first reduced by the direct and indirect expenses, losses, and other deductions to arrive at the entire taxable income.[137] The Treasury Regulations set forth two alternative methods for determining the portion of the entire taxable income that is to be treated as U.S.-source and foreign-source income. For income years beginning on or after November 13, 1998, the methods are[138]:

Business activities method; or
Books and records method.

The business activities method is the method used to compute income within and without the U.S. for Possession Purchase Sales, unless the taxpayer elects to use the books and records method.[139] Under the business activities method, the gross income from Possession Purchase Sales is allocated in its entirety to the taxpayer's business activity. The gross income from the taxpayer's business activity is sourced in the possession in the same proportion that the amount of the taxpayer's business activity for the taxable year within the possession bears to the amount of the taxpayer's business activity for the taxable year both within the possession and outside the possession, with respect to Possession Purchase Sales. The remaining income is sourced to the U.S. [140] For examples of this method, see Treasury Regulation §1.863-3(f)(3)(iii).
For Possession Purchase Sales, the taxpayer can also elect to allocate gross income using the books and records method discussed above. If the taxpayer elects this method, sales are attributable to production and sales activities based on its books and records. Again, to obtain permission to use this method, the taxpayer must establish to the satisfaction of the District Director that the taxpayer, in good faith and unaffected by considerations of tax liability, will regularly maintain its books and records to clearly reflect its transactions.[141] Taxpayers can apply these rules for income years beginning on or after November 13, 1998.[142]

ii. Income Years Beginning On Or After December 30, 1996, But Prior To November 13, 1998

Income derived from the purchase of inventory within a possession of the U.S. and its resale within the U.S. is considered income from sources partly within and

partly without the U.S.[143] Similarly, income from the sale of inventory produced (in whole or in part) within the U.S. and its sale outside the U.S., or from the sale of inventory produced (in whole or in part) outside the U.S. and sold within the U.S., is considered income from sources partly to the place of production and partly to the place of sale.[144] Such sales are referred to as "Section 863 Sales" in the regulations, and income from such sales are treated as income from partly within and partly without the U.S. The word "produced" includes created, fabricated, manufactured, extracted, processed, cured, or aged.[145] The purpose of these rules is to apportion income derived from the production of goods to the country of production and income derived from the sale of those goods to the country of sale.

In determining the amount of taxable income which is partly from U.S. sources, the IRC provides that the gross income realized from such transactions is first to be reduced by the direct and indirect expenses, losses, and other deductions to arrive at the entire taxable income.[146] The Treasury Regulations set forth three alternative methods of determining the portion of the entire taxable income that is to be treated as U.S.-source and foreign-source income. For income years beginning on or after December 30, 1996, the methods are:

- 50/50 method;[147]
- Independent factory price (IFP) method;[148] and
- Books and records method.[149]

The 50/50 method is the method used to compute income within and without the U.S. for "Section 863 Sales", unless the taxpayer elects to use either the IFP method or the books and records method.[150] This method was discussed in Part 1.B.i. of 8.4(g), Water's-Edge Manual, except the method applies to "Section 863 Sales" not Possession Production Sales. Refer to that part. The IFP method was also discussed.[151] An election to use the IFP method is made by using this method to compute U.S.-source income on a taxpayer's return. In contrast, the books and records method can only be used if permission to use this method for "Section 863 Sales" is first obtained from the District Director.[152]

Taxpayers can apply these rules for income years beginning after July 11, 1995, and beginning on or after December 30, 1996.[153]

iii. Income Years Beginning Prior To December 30, 1996

To determine the amount of taxable income which is partly from U.S. sources for income years beginning prior to December 30, 1996, the IRC provides that the gross income realized from such transactions is first to be reduced by the direct and indirect expenses, losses, and other deductions to arrive at the entire taxable income.[154] The Treasury Regulations set forth three alternative methods for determining the portion of the entire taxable income that is to be treated as U.S.-source and foreign-source income. Those methods are:

- Independent factory price (IFP) method (effectively a comparable uncontrolled price.);[155]
- Apportionment of income method;[156] and
- Separate accounting method[157] (if this method more clearly reflects the selling corporation's income from U.S. sources than the preceding two methods).

For income years beginning prior to December 30, 1996, these rules are not elective,[158] nor does the IFP method automatically apply.[159] If there is an IFP and the U.S. manufacturer operates through a foreign sales branch, office, or department, then the IFP method is used to allocate income within and without the U.S. from the sale of inventory produced (in whole or in part) in the U.S.[160] Notice 89-10[161] discusses the application of the IFP method. This notice would apply to the extent it is consistent with the findings of Intel Corporation and Consolidated Subsidiaries vs. Commissioner[162], which were affirmed by the U.S. Court of Appeals on October 15, 1995.

If the U.S. manufacturer does not operate through a foreign sales branch or office, or there is no established IFP, then the apportionment scheme found in TreasRegs. §1.863-3T(b)(2)(Example 2) is used to source income within and without the U.S. for income years beginning before December 30, 1996.[163] Alternately, a taxpayer can request permission to use separate accounting if that method more clearly reflects its U.S.-source income as compared to the other two methods.

As a practical matter, these rules are aimed at determining the division between domestic and foreign-source income from the sale of inventory by a U.S. manufacturer. A foreign corporation will rarely be subject to these rules. The office-source rule (discussed at Part 4 of Section 8.4(g), Water's-Edge Manual)

attributes sales by a foreign corporation through a U.S. office wholly to the U.S. In other words, the IRC precludes foreign persons from using the partly within and without rules to split income derived from the production and sale of inventory between the country of production and the country of sale if such sales are attributable to a U.S. office. (Note, however, that some U.S. tax treaties may override the office source rule. See the discussion in Part 2 of Section 8.4(c), Water's-Edge Manual for more information.)

Even if the sales are not attributable to a U.S. office, it is unlikely that the within and without rule would ever be applied to a foreign corporation. A foreign based manufacturer can easily arrange its transactions so that it does not have income partly from within and partly from without the U.S. (i.e., it will sell its goods FOB shipping point so that title passes outside the U.S.). If the transaction is structured properly, the foreign manufacturer will not have inventory produced within a foreign country and sold within the U.S. because title to the inventory would transfer off-shore. Accordingly, the foreign corporation would not be subject to these rules. Furthermore, a foreign corporation rarely manufactures inventory in the U.S. and sells it outside the U.S. To the extent foreign-based corporations engage in manufacturing in the U.S., they typically do so through U.S. subsidiaries, and the inventory is usually sold to customers in the U.S.

Since the federal sourcing rules are generally relevant for California purposes only to the extent they are used to determine the U.S. income of a foreign corporation, the special rules regarding income from inventory sales, which are considered to be from sources partly within and partly without the U.S., have limited application for California purposes. These rules will not, therefore, be discussed in more detail in this Section.

2. Depreciable Personal Property

The rules regarding the source of income from the sale of depreciable personal property reflect a form of recapture. Gain, to the extent of depreciation allowed or allowable, is allocated within and without the U.S. based on the source of the depreciation deductions. Thus, such gain is allocated to U.S. sources based on the ratio of U.S. depreciation allowed or allowable with respect to the property to the total depreciation allowed or allowable. The remaining portion is sourced outside the U.S.[164] For these purposes, depreciation includes all depreciation reflected in the adjusted basis of such property or other property (as in instances

of carryover basis, such as tax-free exchanges) whether allowed to the taxpayer or to any other person. The term depreciation includes depreciation, amortization, or any other deduction allowable under any provision of the IRC which treats an otherwise capital expenditure as a deductible expense.[165]

Any gain in excess of the amount of allowed or allowable depreciation deductions is sourced as if the property were inventory property. The excess gain, if any, is thus sourced according to the passage of title rules discussed in Part 1A of Section 8.4(g), Water's-Edge Manual.[166]

Example 6:

Lucky Charters, a Bermuda corporation, owns an schooner which travels between the U.S. and Bermuda. Lucky purchased the ship for $10 million and has claimed $3 million in depreciation, of which $1 million was depreciation claimed on its U.S. tax return. Lucky sold the ship in Bermuda in 1995 for $11 million. Of the $4 million gain, $1 million is U.S. sourced [($1 million/$3 million) x $3 million]. The remaining $2 million gain attributable to depreciation claimed is foreign sourced and the $1 million gain in excess of the depreciation is sourced in Bermuda, the place where title passed.

An exception to the above rules is provided for sales by a nonresident which are attributable to its U.S. office or fixed place of business. See the discussion in Part 4 of Section 8.4(g), Water's-Edge Manual, for more information.

3. Intangible Personal Property

The source of income from the sale, exchange, or other disposition of intangible personal property depends on a number of factors. For these purposes, intangible property is defined as any patent, copyright, secret process or formula, goodwill, trademark, trade brand, franchise, or other similar property.[167]

If the payments for the intangible property are contingent upon the sale, productivity, or use of the property, the payments are treated as royalties.[168] Thus, such income would be sourced at the place where the property is used or usable. See Part 2 of Section 8.4(e), Water's-Edge Manual, for a discussion of sourcing rules for royalty income. If the payments are not contingent on the productivity or use of the property, then the following rules apply:

- Gain, to the extent of amortization claimed, will be sourced in the same manner as rules set forth in Part 2 of Section 8.4(g), Water's-Edge Manual, regarding the sale of depreciable property.[169]
- The general residence of the seller rule applies to any gain in excess of amortization claimed.[170] This is in contrast to the passage of title rule which applies to the gain in excess of depreciation claimed on tangible personal property.

Separate rules exist to source intangible income from the sale of goodwill. The statute specifically provides that payments received for the sale of goodwill are sourced to the country in which such goodwill was generated.[171] The statute, however, provides no guidance on how to determine where goodwill was generated. Additionally, any gain from the sale of intangible property which would be sourced to the U.S. under the provisions of the IRC, but which is foreign sourced under a tax treaty, may at the election of the taxpayer be sourced outside the U.S.[172] Any gain from the liquidation of a corporation organized in a U.S. possession which generated more than 50 percent of its gross income for the preceding three-year period was received from the active conduct of a trade or business in the possession is also considered foreign source income.[173] This provision would not apply to an electing IRC Section 936 possession corporation since a possession corporation is domestically organized.[174]

An exception to the above rules is provided for sales attributable to an office or fixed place of business. See Part 4 of Section 8.4(g), Water's-Edge Manual, for more information.

4. Sales Through An Office Or Fixed Place Of Business In The U.S.

Special rules are provided for personal property sold through an office or fixed place of business in the U.S. If a nonresident maintains an office or fixed place of business in the U.S., income from any sale of personal property attributable to such office is sourced in the U.S. regardless of where title passes. This rule does not apply to inventory sold for use or consumption outside the U.S. if an office of the taxpayer in a foreign country materially participated in the sale.[175]

For purposes of sourcing such income, an office or other fixed place of business of an agent is disregarded unless the agent (1) has the authority to negotiate and conclude contracts on behalf of the taxpayer and regularly exercises that authority or has a stock of merchandise from which he regularly fills orders on behalf of the taxpayer, and (2) is not a general commission agent, broker, or other independent agent acting in the ordinary course of his business.[176]

Income is attributable to that office only if the office is a material factor in the realization of the income and the income is realized in the ordinary course of the business carried on through that office. The activities are not considered to be a material factor unless they are an essential economic element in the realization of the income. Thus, for example, meetings in the U.S. of the board of directors of a foreign corporation do not of themselves constitute a material factor in the realization of income.[177]

Example 7:

Bernard Corporation manufactures industrial electrical generators in a foreign country. The generators require specialized installation and periodic maintenance, which only Bernard can provide. Bernard has an office in the U.S. through which it sells generators for use in foreign countries under contracts which provide for installation by the employees of the U.S. office. Title to the generators sold through the U.S. office passes outside the U.S. No other office of Bernard participates materially in these sales. Accordingly, the sales made by the U.S. office are U.S.-source income even though title to the goods passed outside the U.S.

Example 8:

Same as Example 7, except that the sale contracts provide that the installation and maintenance will be performed by Bernard's office in foreign country N. Since the inventory is sold for use outside the U.S. and an office of Bernard performs significant services incident to the sales which are necessary for their consummation, the income is foreign sourced even though the U.S. office participates in the sale.

There are also special rules for U.S. residents that maintain an office or fixed place of business in a foreign country. In general, income from sales of personal

property attributable to such office is sourced outside the U.S. if an income tax equal to at least 10 percent is actually paid on that income to a foreign country.[178]

A U.S. resident is any individual who has a tax home in the U.S. and any domestic corporation, trust or estate.[179] Thus, a foreign corporation is not a U.S. resident for purposes of these rules regardless of how actively it is engaged in a U.S. trade or business.

h. Transportation Income

Transportation income is defined as any income earned in connection with the use, or hiring or leasing for use, of a vessel or aircraft as well as income from the performance of services directly related to the use of a vessel or aircraft. The term vessel or aircraft includes any container used in connection with a vessel or aircraft.[180] The operation of a vessel on the high seas to transport cargo would be considered transportation income rather than income from ocean activities. If a trip begins and ends in the U.S., all transportation income is U.S.-source income regardless of whether the freight is carried within or without the three-mile limit.[181]Thus, if a vessel loads cargo in Alameda, California and travels to Anchorage, Alaska outside the three-mile limit, all income earned on the voyage is U.S.-source income.

Income from transportation services carried on between points in the U.S. and points outside the U.S. is sourced partly within and partly without the U.S. In general, 50 percent of all transportation income (except personal services income related to the transportation income as discussed below) is considered U.S.-source income if the trip begins or ends in the U.S.[182] For example, if a vessel loads cargo in Japan and travels to Long Beach, California, 50 percent of the income earned on the voyage is U.S.- source income.

The personal services portion of transportation income is, with one exception, not subject to the 50 percent rule. The personal services portion is generally sourced where the services are performed. The source rules for income from personal services are discussed at Section 8.4(d), Water's-Edge Manual. However, personal services income attributable to transportation, which begins in the U.S. and ends in an IRC Section 936 possession corporation or begins in an IRC Section 936 possession corporation and ends in the U.S., is subject to the 50 percent rule.[183]

There are limited exceptions to the 50 percent rule for transportation income with respect to certain leased vessels and aircraft.[184] The exceptions are designed to cure a perceived problem in the operation of the foreign tax credit limitation of domestic corporations and should rarely, if ever, impact foreign corporations. As a practical matter, the exceptions should have no implications for California reporting purposes.

i. International Communications Income

International communications income includes all income derived from the transmission of communications or data between the U.S. and any foreign country.[185] Income derived from the transmission of international telephone calls via satellite would be considered international communications income rather that income from space activities. In the case of a U.S. person, 50 percent of the international communications income is sourced in the U.S. and 50 percent is sourced outside the U.S.[186] In the case of a foreign person, international communications income is generally foreign sourced.[187] However, if a foreign person maintains an office or other fixed place of business in the U.S., any international communications income attributable to such office is sourced in the U.S.[188]

j. Space And Certain Ocean Activities

The source of any income derived from a space or ocean activity depends on who is deriving the income. If such income is derived by a U.S. person, the income is sourced in the U.S.[189] If such income is derived by a person other than a U.S. person, it is sourced outside the U.S.[190]

The term space or ocean activity is defined as any activity conducted in space and any activity conducted in water not within the jurisdiction (as recognized by the U.S.) of any country or possession. The term includes any activity conducted in Antarctica.[191] The term does not include any activity giving rise to transportation income (as discussed in Section 8.4(h), Water's-Edge Manual), or any activity giving rise to international communications income (as discussed in Section 8.4(i), Water's-Edge Manual).[192]

The operation of a vessel on the high seas to transport cargo would be considered transportation income rather than income from ocean activities. Similarly, income derived from the transmission of international telephone calls via satellite would be considered international communications income rather that income from space activities.

Space or ocean activity generally includes the performance of services in space or on the high seas, and the leasing of equipment, such as satellites or deep-sea diving bells for use on or beneath the ocean or in space. Deep-sea mining outside the jurisdiction of any country is an example of ocean activity, as is the licensing of technology for use on or beneath the ocean or in space.

k. Income From Natural Resources

Income derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber, is sourced within and without the U.S. in the same manner as inventory produced within the U.S. and sold outside the U.S., or inventory produced in a foreign country and sold within the U.S. (see Part 1B of Section 8.4(g), Water's-Edge Manual, for a discussion of the sourcing rules.[193]

1. Sourcing Income From Natural Resources-Income Years Beginning Prior To January 1, 1997

In Phillips Petroleum Co. vs. Commissioner[194], the tax court held that TreasRegs. §1.863-1(b)(1), which interpreted IRC Section 863(b), was invalid. This regulation had treated income derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber located in the U.S. differently than mixed-source income from the manufacture and sale of personal property. The regulation had provided that this income was "ordinarily" U.S.-source income regardless of whether the products are sold within or without the U.S. Conversely, income from the ownership or operation of such property located in a foreign country was sourced to the country where the property is located. The regulation did not treat income from cross-border natural resource transactions as mixed-source income.

The tax court held that TreasRegs. §1.863-1(b)(1) was invalid because its general rule, which sourced all of the income to one location, was inconsistent with IRC §863(b) which provided for mixed-source income when cross-border transactions are involved. To the extent the regulation conflicted with the mixed-sourced income provisions of the statute, the regulation was held to be invalid. Having held that the income should be allocated within and without the U.S., it was uncontested that TreasRegs. §1.863-3(b) governed the apportionment of mixed source income within and without the U.S.

2. Sourcing Income From Natural Resources-Income Years Beginning After December 31, 1996

As a result of the decision in Phillips Petroleum Co, new regulations were issued effective for income years beginning after December 31, 1996, to determine the source of income from natural resources. These rules are less favorable than the basic IRC §863(b) rules for inventory sales because they do not allow for the sourcing of all gross income under the 50/50 method. Rather, a priority allocation to the location of the natural resource is used based on the application of one of three methods.

A. SOURCING INCOME UNDER THE EXPORT TERMINAL RULE

Under the export terminal rule, sales of natural resources are first allocated to the export terminal based on the FMV of the natural resource immediately prior to export.[195] The source of gross receipts equal to FMV of the product at the export terminal will be sourced to the location where the farm, mine, well, deposit, or uncut timber is located. The source of the excess of the sales price over the FMV of the natural resource at the export terminal depends on whether the taxpayer engages in further production activities. If further production activities occur outside the U.S., the excess of the sales price over the FMV of the product at the export terminal is sourced using either the 50/50 method, the IFP method, or the books and records method.[196] If no further production activities are undertaken, the excess of the sales price over the value at the export terminal is sourced to the country where the sale takes place.[197] If further production activities take place in the country where the natural resources are located, the excess of the sales price over the FMV of the product immediately prior to additional production is sourced using either the 50/50 method, the IFP method, or the books and records method.[198] The FMV of the product at the point where additional production takes place is still sourced to the location where the farm, mine, well, deposit, or uncut timber is located. If the 50/50 method is used, only productions assets used in the additional production activities are taken into account. Furthermore, only production activities of the taxpayer are considered.[199]

B. SOURCING EXPENSES UNDER THE EXPORT TERMINAL RULE

Expenses related to income from natural resources are allocated and apportioned using the rules under TreasRegs. §§1.861-8 through 1.861-14T.[200] Accordingly, expenses incurred up to the point of the export terminal would be allocated to the receipts sourced to the location where they were farmed, mined, deposited, cut or drilled based on the export terminal rule. The excess of the fair value over the export terminal value would be allocated expenses under the more traditional sourcing rules under TreasRegs. §§1.861-8 through 1.861-14T.

C. TAX RETURN DISCLOSURE

Effective for income years beginning on or after January 1, 1997, taxpayers will be required to attach a statement to their return disclosing the methodology used to determine the FMV of the natural resource at the export terminal, and to explain any additional production activities performed by the taxpayer. This is in addition to any other information that the taxpayer is required to provide under TreasRegs. §1.863-3.[201]

3. Definitions

The term U.S. includes the seabed and subsoil adjacent to the U.S. territorial waters.[202] Thus, for example, drilling operations conducted on the U.S. continental shelf would be considered located in the U.S.

I. Summary

The provisions of IRC §861-§865 govern the sourcing of income of a foreign bank or corporation subject to the deemed subsidiary provisions. The following is a summary of the sourcing rules for various types of income:

- Interest is generally sourced at the residence of the debtor.
- Dividends are generally sourced to the country of incorporation of the payer.
- Personal services income is sourced at the location where the services were performed.
- Rents and royalties are sourced at the location where the property is used or usable.
- Gain on the dispositions of real property is sourced at the location of the property.
- Gain on the dispositions of personal property is generally sourced at the residence of the seller. However, this general rule applies in very few situations. The principal exception to the general rule is provided for inventory. Gain on the disposition of inventory is generally sourced at the location where title passes.
- Income from transportation services carried on between points within and without the U.S. is generally sourced 50% to the U.S.
- International communication income of a foreign corporation is generally foreign sourced.
- Income from space and certain ocean activities is sourced based on the country of residence.
- Income from natural resources is sourced within and without the U.S. in the same manner as inventory (i.e., gain on the disposition of inventory is generally sourced at the location where title passes).

Footnotes

1. Helvering v. Suffolk Co., 104 F.2d 505 (4th Cir 1939); Welsh Trust v. Commissioner, 16 T.C. 1398 (1951); De Stuers v. Commissioner, 26 BTA 201 (1932).
2. Howkins v. Commissioner, 49 TC 689 (1968); Bank of America v. US, 680 F.2d 142 Ct. Cl. 1982); Inverworld, Inc. et al, v. Commissioner of Internal Revenue, TC Memo 1996-301 1996).
3. Karrer v. United States, 138 Ct. Cl. 385, 152 F. Supp 66 (1957)
4. IRC 861(a)(1)
5. TreasRegs. 1.861-2(a)(1)
6. TreasRegs. 1.861-2(a)
7. TreasRegs 1.861-2(a)(3)
8. A.C. Monk & Co. Vs. Commissioner., 10 T.C. 77 (1948)
9. Supra note 4
10. 293 U.S. 84, 79 L.Ed 211 (1934).
11. Supra note 4
12. T.C. Memo 1996-301 (1996)
13. 33 T.C. 465 (1959), aff'd in part and rev'd in part, 313 F.2d 313 (8th Cir. 1963)
14. T.C. Memo 196-301 (1996)
15. TreasRegs. 1.861-2(a)(5)
16. IRC 861(a)(1)(A)
17. IRC 861(c)(1)(B)
18. IRC 861(c)(1)(C)
19. IRC 861(c)(2)(A)
20. TreasRegs 1.861-2(b)(2)
21. IRC 861(c)(2)(B)
22. IRC 861(a)(1)(B)
23. TreasRegs 1.861-2(b)(5)
24. TreasRegs. 1.861-3(a)(1)
25. TreasRegs. 1.861-3(a)(2)
26. IRC 861(a)(2)(A)
27. IRC 861(a)(2)(D)
28. IRC 861(a)(2)(B)
29. TreasRegs. 1.861-3(a)(3)(I)(a) has not been modified to reflect the changes made by Public Law 100-647 which reduced the threshold to 25 percent. See IRC 861(a)(2)
30. IRC 861(a)(3) and 862(a)(3)

31. TreasRegs. 1.861-4(a)(1)
32. TreasRegs. 1.861-4(b)(1)
33. Revenue Ruling 60-55, 1960-1 C.B. 270; Bank of America v. U.S. 680 F.2d 142 (Ct. Cl. 1982).
34. Helvering vs. Boekman, 107 F2d 388 (1939); Le Beau Tours Inter-America, Inc., 76-2 USTC 9792, affg DC, 76-1 USTC 9302 (1976)
35. See footnote 34, supra.
36. IRC 861(a)(3)(A) through (C)
37. Treasury Regulation §1.861-18
38. Treasury Regulation Section 1.861-18(a)(3)
39. Treasury Regulation §1.861-18(b)(1)
40. Treasury Regulation §1.861-18(d)
41. IRC 861(a)(4) and 862(a)(4)
42. Revenue Ruling 64-56 , 1964-1 CB 133 modifying Revenue Ruling 55-17, 1955-1 CB 388.
43. Revenue Ruling 60-226, 1960-1 CB 26, modifying Revenue Ruling 58-353, 1958-2 CB 408.
44. 57 USTC 9649 (1957).
45. Commissioner vs. Wodehouse, 337 US 369, 49-1 USTC 9310 (1949); Leisure Dynamics Inc. vs. Commissioner, 74-1 USTC 9328 (1974)
46. Misbourne Pictures Ltd. Vs. Johnson, 50-1 USTC 9348; U.S. vs. Wernentin, 66-1 USTC 9146(1966)
47. The Conde Nast Publications, Inc. vs. U.S., 76-2 USTC 9637; Boulez vs. Commissioner, 83 TC 583 (1984); Commissioner vs. Celanese Corporation of America, 140 F2d 339.
48. TreasRegs 1.861-5
49. 107 T.C. No 10 (1996)
50. In determining that the payments did not constitute U.S.-source income, the court rejected the IRS' position in Revenue Ruling 80-362. Revenue Ruling 80-362 held that royalty payments in the same fact pattern as SDI Netherlands BV were subject to tax under IRC Section 871(a). The court, in rejecting the holding found in Revenue Ruling 80-362, found it to be without reasoning or supporting legal authority.
51. TreasRegs 1.863-4
52. Revenue Ruling 75-483, 1975-2 CB 286.
53. 178 F.2d 987-;50-1 USTC 9123 (1950)(aff'g, rev'g, and rem'g CA)
54. Molnar vs. Commissioner, 156 F.2d 924, 35 AFTR 54 (2d Cir 1946); Misbourne Pictures, Ltd. Vs. Johnston, 50-1 USTC 9348 (1950)
55. 156 F.2d 924, 35 AFTR 54 (2d Cir 1946)

56. SDI Netherlands B.V., 197 T.C. No 10.
57. Treasury Regulation Section 1.861-18(a)(3)
58. Treasury Regulation §1.861-18
59. Treasury Regulation §1.861-18(b)(1)
60. Treasury Regulation §1.861-18(b)(2)
61. Treasury Regulation §1.861-18(c)(2)
62. Treasury Regulation §1.861-18(a)(2)
63. Treasury Regulation §1.861-18(f)(1)
64. Treasury Regulation §1.861-18(c)(3)
65. Treasury Regulation §1.861-18(a)(2)
66. Treasury Regulation §1.861-18(f)(2)
67. Treasury Regulation §1.861-18(e)
68. Treasury Regulation §1.861-18(g)(1)
69. Treasury Regulation §1.861-18(g)(2)
70. IRC 861(a)(5)
71. TreasRegs. 1.897-1(g)
72. IRC 897(c)(1)(A)(ii) and 897(c)(2)
73. Note: IRC 862(a)(8) provides that gains, profits and income from the disposition of a USRPI is foreign source income when the real property is located in the Virgin Islands.
74. IRC 897(c)(1)(A)(I) & 897(c)(6(A)
75. IRC 897(g)
76. IRC 897(c)(1)(A)(ii) & TreasRegs. 1.897-1(c)(2)
77. TreasRegs. 1.897-1(c)(2)
78. IRC 897(c)(1)(B)
79. TreasRegs. 1.897-1(c)(2)(iv)
80. IRC 897(c)(1)(B)
81. IRC 897(c)(1)(B)(ii)(II)
82. TreasRegs 1.897-1(b)(1)
83. TreasRegs. 1.897-1(b)(2)
84. TreasRegs. 1.897-1(b)(3)(I)
85. TreasRegs. 1.897-1(b)(4)
86. TreasRegs. 1.897-1(b)(4)(i)(A)
87. TreasRegs. 1.897-1(b)(4)(i)(B)
88. TreasRegs. 1.897-1(b)(4)(i)(C)
89. TreasRegs. 1.897-1(b)(4)(i)(D)
90. TreasRegs. 1.897-1(b)(4)(ii)
91. IRC 897(c)(2) and TreasRegs. 1.897-2(b)
92. TreasRegs. 1.897-2(c)

93. TreasRegs. 1.897-2(c)(2)(i) & (ii)
94. TreasRegs. 1.897-1(o)
95. TreasRegs. 1.897-2(b)(2)
96. TreasRegs. 1.897-2(b)(2)(iii)
97. TreasRegs. 1.897-2(d)
98. TreasRegs. 1.897-2(e)(1)
99. TreasRegs. 1.897-2(d)(4)
100. TreasRegs. 1.897-2(d)(3)
101. TreasRegs. 1.897-1(f)
102. TreasRegs. 1.897-1(f)(2)(iii)
103. TreasRegs. 1.897-2(e)(2)
104. TreasRegs. 1.897-2(e)(3)
105. TreasRegs. 1.897-2(e)(3)(iii)
106. IRC 865(a)
107. IRC 865(a)(1)
108. IRC 865(a)(2)
109. IRC 865(b)
110. IRC 865(c)
111. IRC 865(d)
112. IRC 865(b), 861(a)(6), and 862(a)(6)
113. IRC 863(b) provides that inventory purchased within a possession and sold within the U.S. is sourced partly within and partly without the U.S.
114. IRC 863(b)(2)
115. IRC 863(b)
116. Revenue Ruling 70-304, 1970-1 CB 163.
117. IRC 865(I)(1)
118. TreasRegs. 1.861-7(c)
119. Ronrico Corp. vs. Commissioner., 44 BTA 1130 (1941); Liggett Group, Inc. vs. Commissioner. 58 TCM 1167, Dec. 46,320(M) (1990). US vs. Balanovski, 236 F2d 298, 56-2 USTC 9832 (1956); Miami Purchasing Service Corp. Inc. and Miami Service Inc. 76 TC 818 (1981); Kales Holding Co. Inc. 79 TC 700 (1982); A.P Green Export vs. US, 284 F. 2d 383(1960).
120. 44 BTA 1130 (1941)
121. 58 TCM 1167, Dec. 46,320(M) (1990)
122. Action on Decision, cc-1991-03
123. Treasury Regulation §1.863-3(f)
124. Treasury Regulation §1.863-3(f)(1)
125. IRC 863(b)

126. Treasury Regulation §1.863-3(f)(2)
127. Treasury Regulation §1.863-3(f)(6)
128. Treasury Regulation §1.863-3(f)(2)(A)
129. TreasRegs. 1.863-3(c)(1)(i)(B)
130. TreasRegs. 1.863-3(c)(1)(ii)(B)
131. TreasRegs. 1.863-3(c)(1)(ii)
132. TreasRegs. 1.863-3(b)
133. Treasury Regulation §1.863-3(b)(2)(ii)
134. Treasury Regulation §1.863-3(f)(2)(i)(C)
135. Treasury Regulation §1.863-3(b)(3)
136. Treasury Regulation §1.863-3(f)(6)
137. IRC 863(b)
138. Treasury Regulation §1.863-3(f)(3)
139. Treasury Regulation §1.863-3(f)(6)
140. Treasury Regulation §1.863-3(f)(3)
141. Treasury Regulation §1.863-3(b)(3)
142. Treasury Regulation §1.863-3(h)
143. IRC 863(b)(3)
144. IRC 863(b)(2)
145. IRC 864(a)
146. IRC 863(b)
147. TreasRegs. 1.863-3(b)(1)
148. TreasRegs. 1.863-3(b)(2)
149. TreasRegs. 1.863-3(b)(3)
150. TreasRegs. 1.863-3(b)(2)(ii)
151. TreasRegs. 1.863-3(b)
152. TreasRegs. 1.863-3(b)(3)
153. Treasury Regulation §1.863-3(h)
154. IRC 863(b)
155. TreasRegs. 1.863-3(b)(2)(Example 1)
156. TreasRegs. 1.863-3(b)(2)(Example 2)
157. TreasRegs. 1.863-3(b)(2)(Example 3)
158. Intel Corporation and Consolidated Subsidiaries vs. Commissioner, 100 T.C. 616 (1993), p. 628; Affirmed; Intel Corporation and Consolidated Subsidiaries vs. Commissioner, 1995 U.S. App. Lexis 28753 (9th Cir., October 15, 1995); Revenue Ruling 1988-2 CB 173.
159. Phillips Petroleum Co. and Affiliated Subsidiaries vs. Commissioner, 97 T.C. 30 (1991).
160. TreasRegs. 1.863-3(b)(2)(Example 1)

161. 1989-1 CB 631
162. 100 T.C. 616 (1993)
163. Intel Corporation and Consolidated Subsidiaries vs. Commissioner, 100 T.C. 616 (1993), p. 628; Affirmed; Intel Corporation and Consolidated Subsidiaries vs. Commissioner, 1995 U.S. App. Lexis 28753 (9th Cir., October 15, 1995); Revenue Ruling 1988-2 CB 173
164. IRC 865(C)(1) & (3)
165. IRC 865(c)(4)
166. IRC 865(c)(2)
167. IRC 865(d)(2)
168. IRC 865(d)(1)(B)
169. IRC 865(d)(4)(A)
170. IRC 865(d)(4)(B)
171. IRC 865(d)(3)
172. IRC 865(h)(2)(A)
173. IRC 865(h)(2)(B)
174. IRC 936(a)(1)
175. IRC 865(e)(2)(B)
176. IRC 864(c)(5)(A)
177. TreasRegs. 1.864-6(b)
178. IRC 865(e)(1)
179. IRC 865(g)(1)and (2)
180. IRC 863(c)(3)
181. IRC 863(c)(1)
182. IRC 863(c)(2)
183. IRC 863(c)(2)(B)
184. Public Law 99-514, IRC 1212(f)(2) & (3)
185. IRC 863(e)(2)
186. IRC 863(e)(1)(A)
187. IRC 863(e)(1)
188. IRC 863(e)(1)(B)(ii)
189. IRC 863(d)(1)(A)
190. IRC 863(d)(1)(B)
191. IRC 863(d)(2)(A)
192. IRC 863(d)(2)(B)
193. Phillips Petroleum Co. vs. Commissioner, 97 T.C. 30 (1991).
194. 97 T.C. 30 (1991).
195. TreasRegs. 1.863-1(b)(1)
196. TreasRegs. 1.863-1(b)(1)(i)

197. TreasRegs. 1.863-1(b)(1)(ii)
198. TreasRegs. 1.863-1(b)(2)
199. TreasRegs. 1.863-1(b)(3)
200. TreasRegs. 1.863-1(c)
201. TreasRegs. 1.863-1(b)(6)
202. IRC 638

Section 8.5 Income Effectively Connected With A U.S. Trade Or Business

Contents:

Training Objectives:

The prior section discussed the federal rules for sourcing income within and without the U.S. Once you have determined that a foreign bank or corporation has U.S.-source income, the next step is to determine what income, if any, is considered effectively connected with the conduct of its U.S. trade or business. This section will discuss the federal effectively connected income (ECI) rules, including relevant tax treaty provisions to the extent they affect the ECI determination for income years beginning prior to January 1, 1992. For income years beginning on or after January 1, 1992, provisions of U.S. tax treaties are

no longer followed for California purposes with respect to limiting includible ECI. [CCR §25110(d)(2)(G)(i)(I).]

As discussed in the introduction, you will need to understand the federal income-sourcing rules, the ECI rules, and the FDAP income rules in order to effectively audit water's-edge returns. Although in many cases the auditor will be able to simply accept the ECI or FDAP income reported on the foreign bank or corporation's federal Form 1120F, there will be cases where the computation of self-reported ECI or FDAP income appears questionable; where a foreign bank or corporation has not filed a federal return because it does not believe that it has a return filing requirement; or where a foreign bank or corporation has U.S.-source income includible in the water's-edge combined report that is not taxable for federal purposes. In cases where this issue is material, you must be able to analyze the facts and determine the source of the deemed subsidiary's income, whether the entity is engaged in a U.S. trade or business; and the amount of net income effectively connected with that trade or business. You must also be able to determine U.S.-source income not effectively connected in with a U.S. trade or business that is includible in the water's-edge combined report.

At the end of this section, you will be able to determine:

1. when a foreign corporation is engaged in a U.S. trade or business;
2. when U.S.-source income is effectively connected with a U.S. trade or business;
3. when foreign-source income is effectively connected with a U.S. trade or business;
4. when a foreign corporation has a permanent establishment in the U.S.;
5. the rules for taxing the gain on the disposition of a U.S. real property interest; and
6. the rules for taxing the earnings of foreign ships and aircraft.

Section 8.6, Water's-Edge Manual will discuss U.S.-source income that is not considered effectively connected with a U.S. trade or business, including the concept of FDAP income. For income years beginning on or after January 1, 1992, all U.S.-source business income that is not considered ECI and taxable for federal purposes is includible in the water's-edge combined report.

a. Trade Or Business Defined

Once you have determined that a foreign corporation has U.S.-source income, you then need to determine whether the foreign corporation has a trade or business in the U.S. The need for this determination is premised on how income effectively connected with a U.S. trade or business, and FDAP income are taxed. Income effectively connected with a U.S. trade or business and the net is subject to the same progressive tax rates as domestic corporations. While FDAP income is subject to a flat 30 percent withholding tax (or a lower tax treaty rate if applicable) on gross income.

The statute provides that a trade or business within the U.S. includes the performance of personal services within the U.S. at any time during the year, but excludes the following activities:[1]

1. Performance of personal services for a foreign employer by a nonresident alien individual temporarily in the U.S. for not more than 90 days during the year. This rule applies only if the individual's compensation for such services does not exceed $3,000.[2]

2. Trading in stocks, securities or commodities, irrespective of who effects the transactions (the taxpayer or an independent broker, agent, custodian or commission agent).[3] In other words, an investor or dealer in stock, securities or commodities generally is not considered to be engaged in a U.S. trade or business regardless of the amount and scope of trading involved.[4] To be excluded however, one of the following conditions that must be met:
   a) Trading in stocks and securities through an *independent* U.S. broker is excluded *unless* the foreign corporation maintains a U.S. office through which, or by the direction of which, trades are effected.[5]
   b) Trading for the foreign corporation's own account is excluded whether the trading is done by the foreign corporation or through an agent, *unless* the foreign corporation is: i) a dealer in securities, or ii) a foreign corporation whose principal business is trading in securities for its own account, if the foreign corporation's principal office is in the U.S.[6]

The Treasury Regulations provide guidelines for determining whether a foreign corporation's principal office is in the U.S. Generally, a corporation is to compare the activities (other than trading in stocks or securities) of the U.S. office with

those of its foreign office. If the corporation carries on most of its investment activities in the U.S., but maintains its general business office in a foreign country, then it will not generally be treated as engaged in a U.S. trade or business.[7]

Neither the IRC nor the Treasury Regulations provide guidance on what constitutes a "trade or business" and court cases in this area are limited. A recent decision, InverWorld, Inc., v. Commissioner,[8] is one of the most detailed court decisions issued discussing whether a foreign corporation is engaged in a U.S. trade or business. In this case, the tax court determined that the taxpayer, a foreign corporation, was conducting a U.S. trade or business through the activities of its subsidiary. The subsidiary had an office in San Antonio, Texas, and was conducting various administrative, investment and trading functions in the U.S. on the taxpayer's behalf. The courts determined that the subsidiary was acting as the taxpayer's dependent agent, and the activities and office of the subsidiary in the U.S. were attributed to the taxpayer since the agent had the authority to negotiate and conclude contracts in the name of the taxpayer. In addition, it regularly exercised that authority.

Once it was determined that the taxpayer had an office or other fixed place of business in the U.S. as a result of the attribution of the activities and office of the subsidiary to the taxpayer, the court then concluded that the taxpayer was conducting a U.S. trade or business since the statutory exemptions for "trading through an independent broker" and "trading for the taxpayer's own account" did not apply.[9] The facts in this case made it difficult to argue with the conclusion that the subsidiary was acting as an agent of the parent, that the subsidiary was conducting significant business activities in the U.S. on behalf of the parent, and thus, the parent was engaged in a U.S. business.

As noted in Section 8.3, Water's-Edge Manual, the determination of what constitutes a U.S. trade or business is a question of fact. The courts have held that substantial, regular, or continuous activities in the U.S. are characteristics of a U.S. trade or business.[10] A foreign partner of a partnership engaged in a U.S. trade or business will be considered engaged in a U.S. trade or business as a result of the attribution of the partnership's activities to the partner.[11]

It is important to note that the foreign corporation is considered engaged in a U.S. trade or business for the entire taxable year if it is so engaged at any time during the taxable year. Below are several examples of whether or not a foreign

corporation is conducting a U.S. trade or business based on the Treasury Regulations and relevant court decisions.

Example 1:

Guide Corporation, a foreign corporation, purchases and sells household equipment through a sales office in the U.S. Guide Corporation is engaged in a trade or business in the U.S. by virtue of its sales activity in the U.S.

Example 2:

ACME PLC, a U.K. corporation, opens an office in the U.S. to promote sales of British goods. The U.S. employees, consisting of salespersons and general clerks, are empowered only to run the office, to arrange for the appointment of distributing agents for merchandise offered by ACME, and to solicit orders. These employees do not have the authority to negotiate and conclude contracts for ACME, nor do they have a stock of merchandise from which to fill orders on ACME's behalf. Any negotiations entered into are under the instruction of the head office in the U.K. and subject to its approval as to any decision reached. The only independent authority the employees have is in the appointment of ACME's U.S. distributors. However, the head office retains the right to approve or disapprove the selection of distributors.

ACME is engaged in a trade or business in the U.S. Regular and continuous activity by a foreign corporation's employees in pursuing the business of the foreign corporation would constitute a trade or business.

Example 3:

Sommers SA, an Argentine corporation, purchased goods in the U.S. for sale to customers in Argentina and negotiated the sale of goods to the Argentine customers in Argentina. Sommers has an employee in the U.S., who inspects the goods, solicits orders, makes purchases, and ensures that the goods are placed in warehouses and aboard ships. The corporation maintains a bank account in the U.S. to provide funds for the employee to purchase goods and pay expenses. The employee has an office in the U.S. where suppliers contact him and the address of the office is used on documents involved in the transactions. The goods are shipped FOB New York. The customer pays all shipping expenses and makes its own marine insurance arrangements.

Sommers SA is engaged in a U.S. trade or business. The numerous and varied activities of the employee in the U.S. on the corporation's behalf constitutes a trade or business. Since title to, and beneficial ownership of, the goods passed in New York, income from the sales to the Argentine customers is considered U.S.-source effectively connected income.[12] (See Part 1A of Section 8.4(g), Water's-Edge Manual for the discussion of FOB.)

It is not necessary that the foreign corporation itself be directly engaged in regular and continuous activity in the U.S. for it to be considered engaged in a U.S. trade or business. If an agent of the foreign corporation engages in activities that would have caused the corporation to be engaged in a U.S. trade or business if it had performed them itself, then the foreign corporation is deemed to be engaged in a U.S. trade or business as a result of the agent's activities on its behalf.[13]

Example 4:

Shellits Co., a U.K. corporation, and Gadgets Inc., a U.S. corporation, enter into an agreement under which Shellits conveys to Gadgets the sole agency for the sales of its products in the U.S. Gadgets agrees not to sell the same kind of products for any other company without the express permission of Shellits. Gadgets also agrees not to sell to any of Shellits' competitors and not to take a financial interest in any competitor. Gadgets assumes the full responsibility for the sales of Shellits' products and acts as guarantor. However, Shellits agrees to share equally with Gadgets any loss incurred up to a specified amount. Under the agreement, Gadgets is to receive a commission based on a percentage of the selling price of the products.

This arrangement is one of an ordinary principal and agent relationship through which Shellits carries on its activities in the U.S. and Shellits is thus engaged in a U.S. trade or business.[14]

1. Election To Treat U.S. Real Property As Effectively Connected With A U.S. Trade Or Business

A foreign corporation, which derives income from U.S. real estate, but is not engaged in sufficient activities to be considered engaged in a U.S. trade or

business, may elect to treat such income as effectively connected with a U.S. trade or business.[15] If this election is made, the income is taxable under IRC §882 even though the taxpayer is not engaged in a U.S. trade of business. Once made, the election remains in effect for all subsequent years, and applies with respect to all income derived from the passive holding of real property located in the U.S., including rents or royalties from mines, wells, or other natural deposits.[16] The election, may however, be revoked with the consent of the Commissioner with respect to any taxable year. Refer to the regulations for more information on how such an election is made.[17]

If this election is not made, the question of when the rental of U.S. real estate is a trade or business is an examination issue. Recently, the courts have generally looked to the level of the taxpayer's activity and whether the taxpayer is actively involved with the real estate investment. Rental income with little activity, such as a triple net lease, would not generally be considered a U.S. trade or business.

For both federal and state purposes, the question of whether income derived from U.S. real property is connected with a U.S. trade or business is important. For federal purposes, if the income is considered ECI, deductions such as interest, depreciation and taxes will be allowed against the income in determining the foreign corporation's tax liability at the same progressive rates paid by domestic corporations. If, however, the taxpayer does not elect to treat the income derived from U.S. real property as ECI and the activities are not sufficient to be considered a U.S. trade or business, then the income will generally be considered FDAP income taxable for federal purposes on a gross basis at the 30 percent (or a lower tax treaty rate) withholding rate with no benefit of deductions from related expenses such as interest, property taxes or insurance.

For state purposes, for income years beginning on or after January 1, 1992, income from U.S. real property is included in the water's-edge combined report net of expenses if it generates either ECI or business FDAP income, and is excluded from the water's-edge combined report only if it generates nonbusiness FDAP income. Accordingly, it would make no difference for California purposes whether the taxpayer had made an IRC Section 882 election. For income years beginning prior to January 1, 1992, income from U.S. real property owned by a deemed subsidiary will only be included in the water's-edge combined report if it is considered ECI for federal purposes or if the taxpayer makes an election to treat the income from the U.S. real property as ECI under IRC Section 882(d).

2. ECI - Special Rules For Eci Characterization

Two special ECI rules are worthy of mention at this point. First, once it has been established that a foreign corporation is engaged in a U.S. trade or business, all income from sources within the U.S. (other than FDAP income or gain or loss from the sale of capital assets) is treated as ECI.

Example 5:

Wizit, a French corporation, is engaged in the business of purchasing and selling electronic equipment. The home office of Wizit is also engaged in the business of purchasing and selling vintage wines. During 1995, Wizit established a branch office in the U.S. to sell electronic equipment to U.S. customers. Wizit is engaged in a U.S. trade or business by reason of this branch activity. The U.S. branch office does not participate in the sale of vintage wine purchased by the home office. The wine activity by itself would not be sufficient to cause Wizit to be considered engaged in a U.S. trade or business because there is no permanent establishment associated with the wine activity.

As a result of advertisements, which the home office places in periodicals sold in the U.S., customers in the U.S. frequently place orders for the purchase of wines with the home office and the home office sold wine directly to such customers in 1995. ECI for 1995 includes both income from sales of electronic equipment by the branch and income from sales of wine by the home office, even though the wine income is not effectively connected with Wizit's electronics equipment business being conducted in the U.S.[18] Obviously, ECI of the home office wine activity and Wizit's electronic equipment business in the U.S. would only be included in the same California combined report computation if the activities were unitary.

Second, the deferral of taxation of ECI for tax purposes does not change the character of the income even if it is received in a year when the taxpayer is not engaged in a U.S. trade or business.[19] If any property ceases to be used or held for use in connection with the conduct of a U.S. business and is disposed of within 10 years after cessation of such activities, the gain is treated as ECI. The removal of property from the U.S. is a constructive sale at the time of removal if an actual sale occurs within 10 years.[20]

Example 6:

During 1995, Middleman Ltd., a U.K. corporation, is engaged in the business of buying and reselling high-performance sports cars in the U.S. on the installment basis. During 1995, Middleman has $12.5 million of net income from its U.S. operations of which $10 million is deferred under the installment method. As of the end of 1995, Middleman ceases its U.S. operations. In 1996, Middleman receives net income of $8.5 million from the installment contracts entered into in 1995. The $8.5 million is taxable as ECI of Middleman in 1996 even though Middleman is no longer engaged in a trade or business in the U.S.

Example 7:

Same facts as in Example 6. During 1996 Middleman distributes it U.S. inventory to its U.K. shareholders and sells other items of office equipment. Any gain recognized on the distribution to the shareholders and the sale of the office equipment is taxable as ECI of Middleman in 1996 even though Middleman is not engaged in a U.S. trade or business during that income year.

Note that the above deferred income rule is in sharp contrast to the rules in effect for income years prior to 1987. Under prior federal law, a foreign corporation had to be engaged in a U.S. trade or business in the year the income was recognized for the income to be considered ECI. (Note: some tax treaty provisions follow the prior statutory rule and may override the IRC provisions. See discussion in Part 2 of Section 8.5(b), Water's-Edge Manual.). The above law change should be kept in mind when reading Treasury Regulation §1.864-3 and §1.864-4, as the federal regulations have not yet been updated and still reflect prior law.

b. Impact Of Tax Treaties On The Determination Of ECI

For purposes of the water's-edge deemed subsidiary provision, U.S. tax treaties will apply for California purposes to the extent they limit the application of the federal ECI provisions for income years beginning prior to January 1, 1992.[21] For income years beginning on or after January 1, 1992, provisions of U.S. tax treaties, to the extent they limit the application of the effectively connected provisions of the Code, are no longer followed.[22] Accordingly, the determination of U.S.-source ECI includible in the water's-edge combined report will depend on which income years are being examined. This section will discuss separately the application of U.S. tax treaties to the determination of ECI for income years beginning before January 1, 1992, and for income years beginning on or after January 1, 1992.

Tax treaties only impact the determination of ECI for foreign corporations incorporated in foreign countries with which the U.S. has a treaty in effect. As discussed in Section 8.3, Water's-Edge Manual, if a foreign corporation is from a country with which the U.S. has an income tax treaty, then it must have a permanent establishment in the U.S. before income effectively connected with a U.S. trade or business can be taxed for federal purposes. Tax treaties require that income be effectively connected with a permanent establishment, not just a U.S. trade or business, in order for the income to be subject to tax. If the foreign corporation is not from a treaty country, then the income effectively connected with their U.S. trade or business will be taxed for federal purposes without consideration of tax treaty permanent establishment rules.

Additionally, some tax treaties may override certain IRC income-sourcing rules, or preclude the treatment of foreign-source income as ECI. For income years beginning prior to 1992, the auditor should be aware of the possible impact of tax treaty provisions on ECI when determining whether a foreign corporation has a permanent establishment in the U.S., and when determining whether a foreign corporation has income effectively connected with a U.S. trade or business.

1. Tax Treaties-What's Their Purpose And Where Can You Find Them

The primary purpose of tax treaties is to eliminate international double taxation resulting from overlapping taxing powers using different rules to tax the same

income. Tax treaty provisions are negotiated between the two countries involved, and take into account the special taxing rules of each country so as to eliminate double taxation problems to the extent possible. Tax treaties also provide for the exchange of information between the two countries involved in order to prevent tax evasion. It is important to note, however, that since California is not a party to U.S. tax treaties, we are unable to obtain any documentation or information from the IRS which they obtained under any treaty provisions. Furthermore, we are not bound to the provisions of U.S. tax treaties, except to the extent they limit the determination of ECI for income years beginning prior to January 1, 1992.

Although treaties are negotiated on a bilateral basis between the two governments involved, and the provisions therefore differ from treaty-to-treaty, the U.S. does have a model income tax treaty which it uses as a starting point for its negotiations with other countries. The Council of the Organization for Economic Cooperation and Development (OECD), of which the U.S. is member country, has also issued a model income tax treaty. The provisions of the U.S. model treaty and the OECD model treaty are very similar. U.S. treaties signed since 1963 generally follow the models. As is the case with the IRC provisions, taxpayers and the government may disagree as to the correct interpretation of treaty provisions. In interpreting treaties to resolve these differences, the U.S. courts look to legislative history (such as State Department Reports, Treasury Department Technical Explanations, and Senate Foreign Relations Committee Hearings). The IRS also issues revenue rulings, revenue procedures, letter ruling, technical advice memoranda, etc., dealing with the interpretation of treaty provisions.

The text of treaties and the Treasury Department Technical Explanation are published in the Cumulative Bulletin for the year in which the treaty was ratified. Cumulative Bulletins should be available in District Office's libraries, the Central Office's libraries, in local law libraries, or through Lexis®-Nexis®.[23] The MSA Technical Resource Section also subscribes to a service, Income Taxation of Foreign Related Transactions,[24] which contains copies of all U.S. income tax treaties. This service, or a similar service, may be available in local law or business libraries as well. As of January 31, 1999, there were 59 income tax treaties in effect, with other tax treaties in various stages of negotiation.[25]

2. Interaction Between Tax Treaties And The IRC

IRC §894 provides that the IRC is to be applied to any taxpayer with due regard to tax treaties which apply to the taxpayer. IRC §7852(d) provides that, in general, tax treaties and the IRC have equal status, neither having preferential status by reason of being a treaty or law. The section does, however, have a savings clause for 1954 treaties. No provision of the IRC, which was in effect as of August 16, 1954, applies in any case where its application would be contrary to any tax treaty obligation in effect on August 16, 1954.

Although IRC §7852(d) provides that tax treaty and IRC provisions have equal status, except with respect to IRC and treaty provisions in effect on August 16, 1954, there are instances where an IRC section, the Public Law enacting a particular IRC section, or the Committee Reports will specifically state whether the Code or the treaty takes precedence. Congress has the power to enact statutes which override previously negotiated treaties.[26] For example, the Foreign Investors Real Property Tax Act of 1980 (FIRPTA), which enacted the provisions relating to treatment of gain on the disposition of U.S. real property interests, overrode conflicting tax treaties.[27]

Similarly, the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) and its Conference Committee Report provide that certain international tax provisions enacted by the 1986 Tax Reform Act do not apply to the extent they conflict with any treaty in effect on October 22, 1986. Certain other 86 Act amendments, relating to the foreign tax credit computation, do apply notwithstanding any conflicting treaty in effect on October 22, 1986.[28]

The impact of the TAMRA provisions on IRC sections which are relevant for California water's-edge purposes is set forth below:

A. As discussed in Part 4 of Section 8.4(g), Water's-Edge Manual, if a foreign corporation maintains an office in the U.S., income from any sale of personal property attributable to such office is sourced in the U.S. unless the property is inventory sold for use outside the U.S. and a foreign office of the corporation materially participated in the sale. TAMRA provided that if a treaty in effect on October 22, 1986, conflicts with this source rule, the treaty will prevail.

B. As discussed in Section 8.4(h), Water's-Edge Manual, income from transportation services carried on between points in the U.S. and points outside the U.S. is generally considered 50% from U.S. sources and 50% from foreign sources. TAMRA provided that if a treaty in effect on October 22, 1986, exempts such income, the treaty will prevail except for foreign tax credit purposes.

C. As discussed in Part 2 of Section 8.4(b), Water's-Edge Manual, interest income received from a so-called 80-20 corporation is considered foreign source income if the 80-20 corporation meets the active foreign business test. As discussed in Section 8.4(c), Water's-Edge Manual, dividends received from a domestic corporation, including an 80-20 corporation, is considered U.S.-source income. (Note that prior to the 1986 Act amendments, interest and dividends paid by an 80-20 corporation were always considered foreign-source income). TAMRA provided that if such income is foreign source under a tax treaty in effect on October 22, 1986, the treaty will prevail except for foreign tax credit purposes.

D. As discussed in Section 8.4(c), Water's-Edge Manual, a portion of dividends received from a foreign corporation is considered U.S.-source income if at least 25% of the foreign corporation's gross income during a base period is connected with the corporation's U.S. business. TAMRA provided that if a treaty in effect on October 22, 1986, conflicts with this source rule, the treaty will prevail.

E. As discussed in Part 2 of Section 8.5(a), Water's-Edge Manual, gain from the sale of business property received in a year in which the corporation is no longer engaged in a U.S. business retains its character as ECI. Many treaties follow the prior statutory rule requiring that the corporation be engaged in a U.S. business in the year in which the income is recognized. TAMRA provided that if a treaty in effect on October 22, 1986, conflicts with the new ECI rule, the treaty will prevail.

TAMRA and its Conference Committee report also provide guidance with respect to any unidentified conflicts between tax treaty and IRC provisions. The committee report states that except as otherwise provided in the 1986 Reform Act and TAMRA, the provisions of the 1986 Act override any treaty provision in effect on October 22, 1986 (the date of enactment of the 1986 Act).[29]

Remember, these rules only impact the California water's-edge combined report for income years beginning prior to January 1, 1992.

3. Tax Treaty Permanent Establishment Rules

Under the IRC, foreign banks and corporations engaged in a U.S. trade or business are taxable on their net income effectively connected with its U.S. trade or business at the normal graduated rates applicable to domestic corporations. However, if the foreign bank or corporation engaged in a U.S. trade or business is from a country that has a tax treaty with the U.S. in effect, the foreign corporation will only be subject to U.S. tax on ECI if it has a permanent establishment in the U.S.

When dealing with a foreign bank or corporation from a treaty country, you must not only determine whether or not it has U.S. trade or business activities, you must also determine whether the deemed subsidiary's activities rise to the level of a permanent establishment as defined in the applicable tax treaty. If they do, then the foreign corporation can be taxed on its income effectively connected to the U.S. trade or business. If the foreign bank or corporation's activities do not rise to the level of a permanent establishment, then for federal purposes the foreign corporation will only be taxed on its FDAP income. Furthermore, if the deemed subsidiary from a treaty country does not have a permanent establishment for income years beginning prior to January 1, 1992, then the foreign corporation's U.S.-source income is not included in the water's-edge combined report.

In general, a foreign corporation does not have a permanent establishment in the U.S. unless it is actively involved in continuous business activities in the U.S.[30] A foreign corporation may be taxed if it has a permanent establishment in the U.S. at any time during the year, even if the permanent establishment does not exist at the time a particular income item is earned.[31] Since taxpayers who are claiming immunity from U.S. tax by virtue of the permanent establishment rules of a treaty must file a federal Form 1120F, disclosing the basis for their "return position",[32] it will usually be obvious when a foreign corporation is taking the position that its activities in the U.S. do not create a permanent establishment in the U.S. (This assumes, of course, that the corporation complies with the federal Form 1120F filing requirements and that, if filed, you are able to obtain a copy.)

Since specific treaty provisions will vary from treaty-to-treaty, you must review the rules of the specific treaty involved to determine if the taxpayer's return position is valid. There are, however, some general concepts regarding the level of presence in the U.S. required to constitute a permanent establishment which are common to all treaties. Generally, there are three tests for determining if a corporation has a permanent establishment.

A. Asset Test -- The asset test looks to which kinds of assets, such as a branch, office, or factory, maintained by the foreign bank or corporation in the U.S., will constitute a permanent establishment.

B. Agency Test -- The agency test looks to the extent to which the activities carried on by an agent, partner, or subsidiary of the foreign corporation will constitute a permanent establishment even if the bank or corporation itself does not maintain a place of business in the U.S.

C. Activity Test -- The activity test looks to the types of specified minimal activities, such as storing, delivering, or purchasing goods in the U.S., which the foreign bank or corporation may engage in without being considered as having a permanent establishment.

The following review of the permanent establishment provisions contained in the U.S. model income tax treaty (1996 draft version) will help to demonstrate how the above rules are put to use. The 1996 Model replaces the 1981 Model, and is drawn from a number of sources including the 1981 Model, the 1995 OECD Model treaty, existing U.S. income tax treaties, recent experience negotiating U.S. tax treaties, current U.S. income tax laws and policies, and comments received from interested parties such as tax practitioners. Only recently negotiated U.S. treaties would reflect the 1996 draft model treaty language and provisions. U.S. treaties negotiated in the 1980's and early 1990's were generally closely patterned after the 1981 model treaty. However, these rules can vary from treaty-to-treaty. The auditor should review the treaty for the country in question in making the permanent establishment determination.

Article 5 of the 1996 U.S.-model treaty contains the following rules for determining if an enterprise has a permanent establishment:

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term permanent establishment includes especially:
   a) a place of management(this criteria was not in the 1981 model treaty);
   b) a branch;
   c) an office;
   d) a workshop; and
   e) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources.

3. A building site or construction or installation project, or an installation or drilling rig or ship used for the exploration or development of natural resources, constitutes a permanent establishment only if it lasts more than 12 months (the 1981 model treaty specified 24 months).

4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:
   a) the use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise;
   b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display, or delivery;
   c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
   d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;
   e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;
   f) the maintenance of a fixed place of business solely for any combination of the activities mentioned in subparagraphs a) to e).

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person-other than an agent of independent status to whom paragraph 6 applies - is acting on behalf of an enterprise and has and habitually exercises in a Contracting State an authority to conclude contracts that are binding on the enterprise, that enterprise shall be deemed to have a permanent establishment in that

State in respect of any activities that the person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4, that if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business as independent agents.

7. The fact that a company that is a resident of a Contracting State controls or is controlled by a company that is a resident of the other Contracting State, or that carries on business in that other State (whether through a permanent establishment or otherwise), shall not constitute either company a permanent establishment of the other.

As can be seen, all three tests are present in the model treaty. Paragraphs 1, 2 and 3 establish an asset test, under which a branch, office, factory, etc., is considered a permanent establishment. Paragraph 5 establishes an agency test, under which a business carried on by other than an independent agent on the corporation's behalf constitutes a permanent establishment. Paragraphs 4 and 6 establish an activity test, under which certain activities do not constitute a permanent establishment.

The following examples demonstrate the tax implications of the permanent establishment rules:

Example 8:

Nicole Co. Ltd., a Japanese corporation, is engaged in the business of manufacturing and selling electronic equipment. Nicole places advertisements for its products in periodicals sold in the U.S. As a result of such advertisements, Nicole frequently makes sales of its products to U.S. customers. To fill its orders from U.S. customers, Nicole rents a warehouse in the Los Angeles foreign trade zone in which it stores a stock of its electronic equipment to enable quick delivery to its customers. Title to the goods passes to the U.S. customer upon their receipt of the goods.

Under the IRC and relevant case law, the activities of Nicole in the U.S. are sufficient to constitute a U.S. trade or business. Further, gain from the sale of the inventory is U.S.-source income since title to the goods passes in the U.S. Under the IRC, this income would be considered U.S.-source income effectively connected with Nicole's U.S. trade or business activities. Pursuant to the Japan treaty, however, the types of activities conducted by Nicole in the U.S. are specifically deemed not to constitute a permanent establishment in the U.S.

As a result of the treaty provisions, Nicole is not subject to U.S. income tax on the income realized from the sale of its inventory in the U.S. because Nicole does not have a permanent establishment in the U.S. For California purposes, Nicole's U.S.-source income and its U.S.-located apportionment factors would not be subject to inclusion in a water's-edge combined report for income years beginning before January 1, 1992. However, for income years beginning on or after January 1, 1992, California no longer follows U.S. tax treaties in determining ECI. Accordingly, Nicole's net income from the sale of inventory in the U.S. would be considered U.S.-source income effectively connected with a U.S. trade or business, which is includible in the water's-edge combined report for income years beginning on or after January 1, 1992.[33] Nicole's effectively connected apportionment factors would also be included in the water's-edge combined report for such income years.

Example 9:

Assume the same facts as in Example 8, except that Nicole is incorporated in Brazil, a country with which the U.S. does not have a tax treaty. Because Nicole's activities are not exempted by a tax treaty, Nicole's income from the sale of inventory in the U.S. is considered effectively connected to a U.S. trade or business and would be subject to U.S. income tax for all income years.

(Note that as a practical matter, it is unlikely that a corporation from a non-treaty country would engage in the types of activities which would subject it to U.S. tax. U.S. taxes could easily be avoided, for example, by simply shipping the goods to the U.S. customers directly from the foreign country and having title pass at the point of shipment outside the U.S. Thus, although the corporation would still be engaged in a U.S. trade or business by reason of its continuous sales activities in the U.S., all of its income would be foreign-source income. (As noted previously,

unless a corporation has an office in the U.S., it is only taxable on its U.S.-source income)).

There is one final important point to keep in mind with respect to the effect of U.S. tax treaty provisions on California's water's-edge deemed subsidiaries. As discussed in Section 8.2, Water's-Edge Manual, the provisions of U.S. treaties are followed for California purposes only the extent they limit the application of the federal ECI rules for income years beginning prior to January 1, 1992.[34] This rule determines whether the foreign corporation has any income or apportionment factors includible in their California return regardless of whether they file on a separate or combined report basis. U.S. tax treaty provisions have no other application for purposes of determining the source of a foreign corporation's income (i.e., U.S. or foreign source), or for determining whether a foreign corporation has sufficient constitutional nexus in California to subject it to California tax. In other words, even though a foreign corporation has no ECI pursuant to a U.S. tax treaty, and therefore has no income or factors subject to inclusion in a water's-edge combined report, it may nonetheless still be considered a California taxpayer by virtue of its activities carried on in California. Accordingly, the foreign corporation will remain subject to at least the minimum franchise tax as a result of its activities in California.

c. Determination Of ECI

Once it has been established that a foreign corporation is engaged in a U.S. trade or business, or that it has a permanent establishment if it is from a tax treaty country, its income effectively connected with the U.S. trade or business or permanent establishment must be determined. The determination of gross income effectively connected with the U.S. trade or business will usually be fairly straightforward. There will be situations, however, where a question will arise as to whether income from investments or extraordinary activities should be considered ECI or FDAP income. In general, the Treasury Regulations provide an asset-use test and a business-activities test for determining whether such income is effectively connected with a U.S. trade or business. The asset-use test asks the question: Are the assets used or held for use in a trade or business in the U.S.? The business-activities test asks the question: Are the activities of the trade or business in the U.S. a material factor in the realization of the income?[35]

In applying the asset-use test or the business-activity test, the regulations provide that "due regard" will be given to how the taxpayer has handled the item on its books and records. However, the accounting test is not in and of itself the sole determining factor. Income may or may not be considered ECI irrespective of how it was recorded for book purposes. The regulations also provide that consideration is to be given to whether the accounting treatment meets GAAP standards for the particular trade or business, and whether the accounting treatment for the item is consistent from year-to-year.[36]

1. Asset-Use Test

The asset-use test is primarily useful when income, gain, or loss of a passive type (e.g., interest, dividends, etc.,) is derived from U.S. sources by a foreign bank or corporation that is not engaged in business activities that normally give rise directly to such income, gain, or loss (such as a foreign corporation engaged in manufacturing or selling goods in the U.S.).[37]

Ordinarily, an asset will be treated as used in, or held for use in, the conduct of a U.S. trade or business if the asset meets any one of the following conditions:

A. The asset is held for the principal purpose of promoting the present conduct of the U.S. trade or business.

B. The asset is acquired and held in the ordinary course of the U.S. trade or business, such as accounts or notes receivable arising from the U.S. business activities.

C. The asset is otherwise held in a direct relationship to the trade or business conducted in the U.S. In determining whether an asset is held in a direct relationship to the U.S. trade or business, principal consideration is given to whether the asset is needed in the business. An asset is considered needed in a U.S. trade or business only if the asset is held to meet the present needs of the business and not its anticipated future needs. An asset is considered needed in the U.S. trade or business if, for example, the asset is held to meet current operating expenses. Conversely, an asset is not considered needed in the U.S. business if, for example, the asset is held for the purpose of providing for: i) future diversification into a new business, ii) expansion of business activities conducted outside the U.S., iii) future plant replacement, or iv) future business contingencies.[38]

The Treasury Regulations provide that, except for stock held by foreign insurance companies, stock of a corporation (foreign or domestic) is not considered an asset used in, or held for use in, the conduct of a trade or business in the U.S. Accordingly, dividends and gains or losses related to stock of a corporation will not be considered ECI under the asset-use test. Nor would they be treated as ECI under the business activity test discussed in Part 2 of Section 8.5(c), Water's-Edge Manual 8-5(c)(2) unless the maintenance of the investments in a stock portfolio constitute the principal activity of that trade or business.[39]

The Treasury Regulations provide a rebuttable presumption that an asset is being held in a direct relationship to the U.S. business, if:

- the asset was acquired with funds generated by the business,

- the income from the asset is retained or reinvested in the business, and

- personnel who are present in the U.S. and actively involved in the conduct of the U.S. trade or business exercise significant management and control over the investment of the asset.[40]

The asset-use test is very similar to UDITPA's "functional" test used to determine if income is business or nonbusiness. The major difference is that the functional test does not contain a "present needs" requirement for the income to be considered business income.

The following examples illustrate the asset-use test:

Example 10:

Tia Ltd., a foreign corporation, manufactures toys in Singapore. Tia maintains a branch in the U.S. which acts as an importer and distributor of the toys manufactured in Singapore. By reason of its branch activities, Tia is considered to have a permanent establishment in the U.S. The branch in the U.S. is required to hold a large current cash balance for business purposes, but the amount of the cash balance required varies because of the fluctuating seasonal nature of the branch's business activities. During 1995, at a time when large cash balances are not required, the branch invests the surplus amount in U.S. T-bills. Since the T-bills are held to meet the present needs of the U.S. business they are held in a direct relationship to that business, and the interest on the bills is considered ECI.[41]

Example 11:

Ricardo SA, a Malaysian corporation, has a branch office in the U.S. where it sells various products manufactured by Ricardo in Malaysia to customers located in the U.S. By reason of this activity, Ricardo is engaged in a U.S. business. During 1995, the U.S. branch manager establishes a fund, which is periodically credited with amounts derived from the business activities carried on by the branch. The amounts deposited in this fund are invested by the U.S. branch manager, who is responsible for maintaining proper investment diversification, in various stocks and securities issued by domestic corporations. During 1995, the branch office received dividends from these securities and recognizes gains and losses resulting from the sale of such securities.

Since the securities were acquired with amounts generated by the business conducted in the U.S., the dividends and proceeds from the sale of the securities are retained in that business, and the portfolio is managed by personnel actively involved in the conduct of the U.S. business, the securities are presumed to be held in a direct relationship to the U.S. business. Ricardo SA is able, however, to rebut this presumption by demonstrating that the fund was established to carry out a program of future expansion and not to meet the present needs of the business conducted in the U.S. Consequently, gains and losses from the securities for 1995 are not effectively connected for that year with the conduct of Ricardo's U.S. trade or business.[42] Dividend income would not have been considered ECI even if the presumption was met. However, the dividends would be considered U.S.-source FDAP income subject to federal withholding tax and includible in the water's-edge combined report net of applicable expenses.

2. Business-Activities Test

The business-activities test ordinarily applies when it is necessary to make a determination with respect to income which, even though generally of the passive investment type, arises directly from the active conduct of the foreign bank or corporation's U.S. trade or business. The business-activities test is of primary significance, for example, where gain is derived from the disposition of capital assets in the active conduct of a business by an investment company, where royalties are derived in the active conduct of a business consisting of the licensing of patents or similar intangible property, where interest or dividends are received by a dealer in stocks or securities, or where service fees are derived in the active conduct of a servicing business.

In applying the business-activities test, activities relating to the management of investment portfolios are not treated as activities of the U.S. business unless the maintenance of the investments constitutes the principal activity of that business. Special rules, discussed in Part 3 of Section 8.5(c), Water's-Edge Manual, also apply to corporations conducting a banking, financing, or similar business.[43] The business-activities test is very similar to UDITPA's "transactional" test used to determine if income is business or nonbusiness.

Example 12:

Anderson PLC, a U.K. corporation, has a branch in the U.S., which acts as an importer and distributor of merchandise. During 1995, the branch activities are sufficient for Anderson to be considered to have a permanent establishment in the U.S. Anderson also carries on a business in which it licenses patents to unrelated persons in the U.S. for use in the U.S. The licensees' businesses have no direct relationship to the business carried on by the branch, although the merchandise marketed by the branch is similar in type to that manufactured under the patents.

The negotiations and other activities leading up to the consummation of the licensing agreements are conducted by employees of Anderson who are not connected with the U.S. branch. The royalties received by Anderson from these licenses are not effectively connected with the business of the U.S. branch since the activities of that business are not a material factor in the realization of such income.[44] However, the royalties received represent U.S.-source FDAP income subject to 30% withholding or the applicable tax treaty rate. This U.S.-source FDAP income would be includible in the water's-edge combined report net of related expenses.

3. Special Rules - Banks And Financials

Special rules apply to banks and financial corporations for purposes of determining if income from stocks and securities is effectively connected with the conduct of their banking, financing, or similar business activities in the U.S. Banks and financial corporations do use the asset-use test and the business-activity test to determine whether income other than from stocks and securities is effectively connected with their U.S. trade or business.[45]

A. Banking Or Financial Activities Defined

Although the definition of financial activities for federal ECI purposes is very similar to California's definition of financial activities, there are some important differences. For purposes of applying the ECI provisions, a foreign corporation is considered engaged in the active conduct of a banking, financing, or similar

business in the U.S. if at some time during the year the corporation is engaged in business in the U.S. and the U.S. activities of the business consist of any one or more of the following activities carried on in transactions with persons located within or without the U.S.:

- Receiving deposits of funds from the public;
- Making personal, mortgage, industrial, or other loans to the public;
- Purchasing, selling, discounting, or negotiating for the public on a regular basis, notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness;
- Issuing letters of credit to the public and negotiating drafts drawn thereunder;
- Providing trust services for the public; or
- Financing foreign exchange transactions for the public.

A foreign corporation, which acts merely as a financial vehicle for borrowing funds for its parent corporation or any other related person, is not considered to be engaged in the active conduct of a banking, financing or similar business in the U.S.[46] Thus, unlike the California rules, the federal rules do not consider a "captive financial" subsidiary as being engaged in the financing business.

In determining whether a foreign corporation is engaged in the banking or financing business in the U.S., the character of the business actually carried on during the year in the U.S. is the deciding factor, although consideration is given to the fact that the corporation is subjected to the banking and credit laws of a foreign country.[47]

It is important to note the above federal definition of U.S. banking or financial activities applies for California purposes only for purposes of determining the amount of taxable ECI. The California definition of bank and financial activities still applies for purposes of determining if the entity is subject to the financial tax rate, and whether CCR §25137-4 applies.

B. Effective Connection Of Income From Stocks Or Securities Associated With A Banking Or Financing Business

Any U.S.-source dividends or interest from stocks or securities, or any U.S.-source gain or loss from the disposition of stocks or securities which are capital assets, earned by a foreign corporation engaged in the active conduct of a

banking, financing, or similar business are treated as ECI if the stocks or securities giving rise to the income are attributable to the U.S. office and:[48]

- Were acquired in the course of making loans to the public, in the course of distributing such stocks or securities to the public, or for the purpose of satisfying reserve or other similar requirements established by U.S. banking authorities;[49] or

- Consist of securities which are payable on demand or with a maturity date not exceeding one year, or are issued by the U.S. or any agency or instrumentality of the U.S.[50]

A stock or security is considered to have been acquired in the course of making loans to the public if, for example, the stock or security was acquired as additional consideration for making the loan or the stock or security was acquired by foreclosure upon a bona fide default of the loan.[51]

In addition to the income from securities which meet requirements 1 or 2 above being considered ECI, the Treasury Regulations provide that a portion of the interest or gain/loss from the disposition of securities which do not meet the above tests is also considered ECI. The portion of interest or gain or loss from the disposition of such securities considered ECI is determined by the following formula:

		10%
U.S. source interest Income or gain/loss from disposition of such securities	X	**Over** ratio of book value of securities to total assets of branch office (ratio based on monthly average of such assets)

Note that this formula is applied to U.S.-source interest, gains and losses. Therefore, the portion of the interest, gains and losses that the formula determines to be not ECI is still U.S.-source income and will be includible in the water's-edge combined report effective for income years beginning on or after January 1, 1992.

Stocks or securities are defined as any bill note, debenture, or other evidence of indebtedness, or any evidence of an interest in, or right to subscribe to or purchase any of these items.[52]

In addition to the above rules, receipts from stocks or securities will only be attributed to a U.S. office if the office actively and materially participates in soliciting, negotiating, or performing other activities required to arrange the acquisition of the stock or security. However, the U.S. office need not have been the only active participant in arranging the acquisition of the stock or security.[53] However, a stock or security is not deemed to be attributable to a U.S. office merely because the office conducts one or more of the following activities:

- Collects or accounts for the income from the stocks or securities;
- Exercises general supervision over the people soliciting, negotiating, or carrying on other activities required to arrange the acquisition of the stock or security;
- Performs clerical functions incidental to the acquisition of the stocks or securities;
- Exercises final approval over the execution of the acquisition of the stocks or securities;
- Holds the stock or securities in the U.S. or records the stock or securities on its books as having been acquired by the office or for its account.[54]

Example 13:

Lotta Yen Bank, a Japanese corporation, has worldwide banking operations, including a branch office in the U.S., which is engaged in the active conduct of a banking business in the U.S. In the course of its banking business in foreign countries, Lotta Yen (Japan) receives substantial deposits in U.S. dollars at its branches located in Japan, and other foreign countries, which it transfers to the accounts of the branch in the U.S.

During 1995, the U.S. branch actively participated in negotiating loans to residents of the U.S., which are financed from the U.S. dollar deposits transferred to the U.S. branch by Lotta Yen (Japan). In addition, the branch actively participated in purchasing long-term bonds and notes issued by the U.S. Government, U.S. T-bills, and long-term interest bearing bonds issued by domestic corporations having a maturity date of less than one year. All of these securities were purchased using the deposits transferred to the branch by Lotta

Yen (Japan). All of the securities acquired are held by the branch and recorded on its books in the U.S. The interest received during 1995 from these securities is effectively connected with the active conduct by Lotta Yen of a banking business in the U.S.[55]

Example 14:

Monarch Bank, a French corporation, is engaged in the worldwide conduct of a banking business. Monarch Bank has a branch in the U.S., which is engaged in the active conduct of a banking business in the U.S. The U.S. branch handles the negotiation and acquisition of securities involved in loans made by Monarch Bank to U.S. persons. The branch also presents interest coupons with respect to the securities for payment, presents all the securities for payment at maturity, and maintains complete photocopy files of the securities. Monarch's office in France gives pro-forma approval of the loans, stores the original securities, and records the securities on the its books.

The U.S.-source interest income received by Monarch on these securities is effectively connected with the U.S. branch's banking business.[56]

d. Foreign-Source ECI

A foreign corporation engaged in a U.S. trade or business at any time during the year may be subject to U.S. tax on certain classes of foreign-source income which are treated as ECI under the IRC. For all income years, CCR §25110(d)(2)(G) provides that foreign-source income which is treated as ECI is deemed derived from or attributable to sources within the U.S., and as such, is included in the water's-edge combined report. For income years beginning on or after January 1, 1992, provisions of U.S. tax treaties, to the extent they limit the application of the ECI provisions of the IRC, are not followed in making the determination whether the foreign-source income is treated as effectively connected with a U.S. trade or business.[57]

Foreign source income may be considered ECI if:

1. The foreign-source income consists of:
   a) Certain rents, royalties, or gains on sales of intangible property;[58]
   b) Dividends, interest, or gain/losses from sales of stocks and securities realized by: (i) a foreign corporation in the active conduct of a banking, financing, or similar business in the U.S., or (ii) a foreign corporation whose principal business is trading in stocks or securities for its own account;[59] or
   c) Income, gain, or loss from the sale of property held primarily for sale to customers in the ordinary course of business;[60] and

2. The foreign corporation has a U.S. office or other fixed place of business in the U.S. to which the income in question is attributable.

Except for these three specific classes of income, no other foreign-source income will be considered effectively connected with a U.S. trade or business.[61]

There are several major exceptions to the above rules. First, foreign-source interest, dividends, or royalties paid by a foreign corporation in which the taxpayer owns more than 50% of the stock are not treated as ECI. Secondly, Subpart F income is not be treated as ECI.[62] Finally, goods or merchandise destined for foreign use or consumption will not be treated as ECI if a foreign office of the taxpayer was a material factor in the realization of the income.[63]

1. DETERMINATION OF EXISTENCE OF OFFICE OR OTHER PLACE OF BUSINESS

For purposes of determining whether foreign-source income will be treated as ECI, the foreign bank or corporation must have an office or other fixed place of business in the U.S. An office or other fixed place of business is a fixed facility through which the foreign bank or corporation engages in a trade or business in the U.S. This would include a factory; a store or other sales outlet; a workshop; or a mine or other place of extraction of natural resources. A fixed facility may be considered an office or other fixed place of business whether or not the facility is continuously used by the foreign bank or corporation.[64]

In making the determination as to whether a foreign bank or corporation has an office or other fixed place of business in the U.S., due regard is given to the facts and circumstances of each case, particularly to the nature of the bank or corporation's business and the physical facilities actually required to conduct the business.[65] The law of a foreign country is not controlling in determining whether a foreign bank or corporation has an office or other fixed place of business in the U.S.[66]

Use of another person's office or other fixed place of business will not cause a deemed subsidiary to meet the office requirement if its business activities through that office are relatively sporadic or infrequent.[67] Furthermore, a foreign bank or corporation is not considered to have an office or other fixed place of business merely because a person controlling it has an office or other fixed place of business in the U.S. from which general supervision and control over the policies of the foreign bank or corporation are exercised.[68]

The U.S. office or other fixed place of business of a dependent agent (i.e., someone who is not a general commission agent or other independent agent acting in the ordinary course of his business) may be considered in determining whether a foreign corporation has an office or other fixed place of business in the U.S. only if the agent has:

- authority to negotiate and conclude contracts in the name of the foreign corporation, and regularly exercises that authority; or

- a stock of merchandise belonging to the foreign corporation from which order are regularly filled on behalf of the foreign corporation.[69]

Thus, for example, if a domestic corporation regularly negotiates and concludes contracts in the name of a foreign affiliate or maintains a stock of inventory from which it regularly fills orders on behalf of the foreign affiliate, the office or other fixed place of business of the domestic corporation is treated as the office of the foreign bank or corporation unless the domestic corporation is an independent agent.[70]

The office of an independent agent is not treated as an office of his principal regardless of whether the agent has authority to negotiate and conclude contracts for the principal or maintains a stock of inventory for filling orders on behalf of the principal.[71] An independent agent means a general commission agent, broker, or other agent of an independent status acting in the ordinary course of his business. An independent agent can be related to the foreign corporation. Refer to Taisei Fire and Marine Insurance Co., Ltd.[72] for a discussion on when a U.S. agent creates a permanent establishment in the U.S. on behalf of its principal.

The above "agent" limitation does not apply if an employee of the foreign corporation, in the ordinary course of his duties, regularly carries on the business of his employer through a fixed facility in the U.S. Such facility is considered an office of the employer even if the employee doesn't have the authority to negotiate and conclude contracts or have a stock of inventory for filling orders.[73]

2. INCOME ATTRIBUTABLE TO AN OFFICE OR OTHER PLACE OF BUSINESS

Once it has been determined that an office or other fixed place of business exists in the U.S., the next step is to determine whether there is any foreign-source income of the foreign corporation attributable to that office. Foreign-source income is considered attributable to the U.S. office if the office is a material factor in the realization of the income and if the income is realized in the ordinary course of the trade or business carried on through that office. The office must be an essential economic element in the realization of the income in question. It is not necessary that the U.S. activities be a major factor in the realization of the income. In addition, a U.S. office may be a material factor in the realization of the income even though the office is not in existence in the U.S. when the income is actually realized.[74] If the U.S. office is a material factor in the realization of the income, then the amount of income which is considered

allocable to the U.S. office or other fixed place of business shall not exceed the amount which would be treated as income sources within the U.S. if the taxpayer had sold the goods or merchandise in the U.S.[75]

The regulations discuss the application of the material factor test to each of the three classes of foreign-source income which may be considered ECI.[76] In general, foreign-source income will be attributed to a U.S. office if the office actively participates in soliciting, negotiating, or performing other activities required to arrange the transaction from which such income is derived, or performs significant services incident to the transaction. However, a U.S. office is not considered to be a material factor in the realization of such income merely because the office conducts one or more of the following activities:

A. Develops, creates, produces, or acquires and adds substantial value to the property which is leased, licensed, or sold;
B. Has final approval of the transaction;
C. Holds and distributes the property sold from the office;
D. Displays samples of the property sold in the office;
E. Collects or accounts for the income;
F. Exercises general supervision over the activities of the persons directly responsible for carrying on the activities or services described in b; or
G. Performs merely clerical functions incident to the transaction.[77]

Example 15:

Spuds NV, a foreign corporation, is engaged in the active conduct of the business of licensing patents, which it either purchased or developed in the U.S. Spuds has an office in the U.S. Licenses for the use of its patents outside the U.S. are negotiated by offices of Spuds located outside the U.S., subject to approval by an officer of Spuds located in the U.S. office. All services which are rendered to Spuds foreign licensees are performed by employees of Spuds offices located outside the U.S. As a result, none of the income resulting from the foreign licenses negotiated by Spuds is attributable to its business office in the U.S.[78]

Any foreign-source income which is considered ECI is deemed derived from or attributable to U.S. sources, and is included in the water's-edge combined report. For income years beginning on or after January 1, 1992, U.S. tax treaties are ignored for purposes of determining whether foreign-source income is ECI.

e. Dispositions Of U.S. Real Property Interests

As discussed in detail in Section 8.4, Water's-Edge Manual, IRC §897 provides that foreign corporations are subject to U.S. tax on gains from the disposition of U.S. real property interests (USRPI). The definition of USRPI is discussed in Part 1 of Section 8.4(f), Water's-Edge Manual. Gain or loss realized from the disposition of a USRPI is treated as if it is effectively connected with a U.S. trade or business.[79] Thus, a foreign corporation is taxed on such income pursuant to IRC §882 regardless of whether the foreign corporation is actually engaged in a U.S. trade or business. (As a practical matter, most corporations will have an IRC §882(d) election in effect to treat income from real property as income effectively connected with a U.S. trade or business to obtain the benefit of deductions for depreciation, interest, property taxes, etc.)

The provisions of IRC §897 (commonly referred to as FIRPTA, the acronym for the Foreign Investment in Real Property Tax Act, which enacted the IRC §897 provisions) generally apply to dispositions of a USRPI after June 18, 1980. While the details of FIRPTA are very complex, the basic concept is fairly straightforward. The purpose of FIRPTA is to tax foreign persons on their dispositions of both direct interests in U.S. real property and indirect interests in USRPI's held in corporate form (stock).

For all income years, ECI is included in the water's-edge combined report. ECI includes income which is effectively connected, or treated as effectively connected income under the IRC.[80] Since U.S. tax treaties cannot override the FIRPTA provisions, gain or loss from the disposition of a USRPI, will always be subject to inclusion in the water's-edge combined report because the gain or loss is always treated as ECI. In addition, any periodic income attributable to the USRPI, which is treated as ECI as a result of an IRC §882(d) election, would also be included in a water's-edge combined report for income years beginning prior to January 1, 1992. For income years beginning on or after January 1, 1992, any periodic business income generated by U.S. real property would be including in the water's-edge combined report regardless of whether it was treated as ECI or not, since income from U.S. real property is U.S.-source income. If periodic income generated by U.S. real property is considered nonbusiness income under the functional and transactional tests, it cannot be included in the California water's-edge combined report even if the property is located in California (unless an IRC §882(d) election has been made to treat the income from the USRPI as ECI).

It is important to note, however, that there are some significant differences between federal and California law with respect to whether a gain realized on the disposition of a USRPI is to be recognized for tax purposes. These differences are discussed briefly below.

For FIRPTA purposes, a disposition is any transfer of a USRPI if the transfer is considered a disposition under the IRC and the Treasury Regulations.[81] Thus, dispositions include not only a sale, but also transactions such as redemptions, transfers in reorganizations, contributions to capital, and liquidating or nonliquidating distributions. For example, distributions received by a foreign shareholder from a U.S. real property holding corporation (USRPHC) are treated as a disposition of a USRPI by the foreign corporation if the distribution is: a) treated as a sale or exchange of stock under IRC §301(c)(3)(A); or b) treated as a stock redemption pursuant to IRC §302(a); or c) treated as a complete liquidation pursuant to IRC §331(a).[82] Each of the these transactions involves an actual or constructive sale or exchange of the USRPHC stock by the foreign shareholder. These transactions are taxable events for both federal and state purposes.

For federal purposes, FIRPTA contains a number of special rules, which restrict a foreign corporation's right to make use of the normal tax nonrecognition provisions. California has not conformed to IRC §897. As a result of California's failure to conform to IRC §897, the FIRPTA nonrecognition override provisions do not apply for California purposes. In other words, while any recognized gain from the disposition of a USRPI is treated as ECI in accordance with the federal provisions, and is thereby subject to inclusion in the water's-edge combined report, the determination of whether or not such gain realized is recognized for California tax purposes is determined under the normal California rules.

You should be aware, therefore, that there may be situations where gain has been recognized for federal purposes under IRC §897, but no gain is required to be recognized for California purposes. In such cases, obviously, the gain is not includible in the water's-edge combined report.

1. FIRPTA Nonrecognition Override Provisions

The FIRPTA nonrecognition override provisions are found in IRC §897(d) and §897(e). IRC §897(d) sets forth the general rule that if a foreign corporation distributes a USRPI (including a distribution in redemption or liquidation) to its shareholders, the foreign corporation must recognize gain (but not loss) on the distribution to the extent the FMV of the property exceeds the corporation's basis in the property.[83] A statutory exception to this rule is provided. Gain will not be required to be recognized under IRC §897(d) if the following three conditions are met:

- At the time of receipt of the distributed USRPI, the recipient would be subject to U.S. tax on a subsequent disposition of the USRPI;

- The recipient's basis in the USRPI is not greater than the adjusted basis of the property before the distribution, increased by the amount of any gain recognized by the distributing foreign corporation upon distribution (i.e., the foreign corporation's "inside" basis in the property cannot be less than the shareholder's "outside" basis in the stock of the foreign corporation);[84] and

- The distributing foreign corporation complies with certain filing requirements set forth in the regulations.[85] In general, the foreign transferor must file an income tax return for the year of the distribution even if a nonrecognition provision will be applicable and no U.S. tax is due. The return must describe the USRPI, identify the recipient of the USRPI, and contain a declaration signed by the recipient that they will treat any subsequent disposition of the USRPI as a disposition that is subject to U.S. tax, regardless of any intervening change in circumstances.

IRC §897(e) and TreasReg. §1.897-6T(a)(1) provide that a nonrecognition provision of the IRC (e.g., IRC Sections 332, 351, 354, 355, 361, 1031, 1033, 1034, 1036, etc.,) will only apply to exchanges when the disposing foreign corporation receives another USRPI which, immediately following the exchange, would be subject to U.S. tax upon its disposition, and the transferor complies with the filing requirements set forth in TreasReg. §1.897-5T(d)(1)(iii) discussed above.

For a detailed analysis of the taxability of corporate distributions under FIRPTA, refer to Treasury Regulation §1.897-5T and §1.897-6T. These regulations were issued in May, 1988, and are fairly complex. They discuss and provide numerous examples of the various types of dispositions which will, or will not, be

free of U.S. tax. Treasury Regulation §1.897-5T principally covers distributions under IRC §897(d), with Treasury Regulation §1.897-5T(b) covering distributions by domestic corporations and Treasury Regulation §1.897-5T(c) covering distributions by foreign corporations. Treasury Regulation §1.897-6T covers the nonrecognition rules of IRC §897(e). Since the rules do not apply for California purposes, they will not be discussed in great detail in this section. They are briefly discussed in order to make you aware of the types of situations where gain recognized and reported on the federal return may not be taxable for California purposes.

Some of the more important FIRPTA nonrecognition override provisions, which do not apply for California purposes are as follows:

- Gain is generally required to be recognized by a foreign corporation on the transfer of a USRPI to a foreign corporation if the transfer is made as paid-in surplus or as a contribution to capital to the extent of the FMV of the property transferred exceeds the adjusted basis plus the amount of any gain recognized by the transferor.[86]

- A foreign corporation that distributes stock in a USRPHC in an IRC §355 distribution must recognize gain on the distribution to the extent that the FMV of the distributed stock exceeds the distributing corporation's adjusted basis in the stock. The gain recognized is limited, however, to the amount by which the basis of the stock in the hands of the distributee exceeds the distributing corporation's basis in the stock (i.e., to the extent "outside" basis exceeds "inside" basis). In addition, the distributee's basis in the stock is determined under the otherwise applicable provisions of IRC §358. (In other words, the distributee's basis in the stock is not increased for any gain recognized by the distributing foreign corporation).[87]

- A foreign corporation that distributes to its shareholders stock in a USRPHC which it received under a "C", "D", or "F" reorganization must recognize gain on the distribution to the extent the FMV of the stock exceeds the distributing corporation's basis in the stock.[88] As is the case with IRC §355 distributions, the gain recognized is limited to the amount by which the basis of the stock in the hands of the distributee exceeds the distributing corporation's basis in the stock. The distributee's basis in the stock is determined under the provisions of IRC §358.[89]

- If a domestic corporation (stock in which is treated as a USRPI) makes an IRC §355 distribution of stock in a domestic or foreign corporation that is not a USRPHC to a foreign person, the foreign person is considered as having exchanged part of the stock of the domestic corporation (that is a USRPI) for stock that is not a USRPI. As a result, the distributee has not met the USRPI for USRPI exception of IRC §897(e), and the gain on the distribution would be subject to U.S. tax.[90]

2. Election To Be Treated As A Domestic Corporation (The IRC §897(i) Election)

Any foreign corporation may make an election to be treated as a domestic corporation for purposes of IRC §897, if at the time of the election:

A. The corporation owns a USRPI;

B. under any tax treaty obligation, the foreign corporation is entitled to nondiscriminatory treatment with respect to the USRPI; and

C. the conditions and disclosure requirements set forth in TreasReg §1.897-3(c) are met.[91]

In general, Treasury Regulation §1.897-3(c) provides that the corporation must provide a statement indicating it is making the election, the U.S. tax treaty under which it is seeking nondiscriminatory treatment, and a description of the USRPI, including its adjusted basis and FMV.[92]

A foreign corporation, which makes the election, effectively becomes a USRPHC and any disposition its stock by its foreign shareholder(s) will be considered a disposition of a USRPI. The IRC §897 "i" election is the exclusive remedy for any person claiming discriminatory treatment under a U.S. tax treaty obligation. If the election is not properly made, the tax treaty's nondiscrimination provisions will not apply.[93]

Why would a foreign corporation elect to be treated as a USRPHC? Because, to some extent, a foreign corporation can avoid the FIRPTA nonrecognition override provisions by making the "i" election. (As discussed above, many of the nonrecognition override provisions apply only to dispositions by foreign

corporations). Since the enactment of the 1986 Act, however, the significance of the "i" election has been reduced. Prior to the 1986 Act, one of the most significant differences between a U.S. and a foreign corporation was the availability of tax-free liquidation treatment under IRC §337. A foreign corporation could not get tax-free IRC §337 treatment on the sale of its USRPI. The "i" election allowed foreign corporations from tax treaty countries to alleviate this "discriminatory" treatment between domestic and foreign corporations.

The "i" election continues to work to allow foreign corporations to receive nonrecognition treatment on certain liquidations, reorganizations, and IRC §355 distributions, which would otherwise be taxable under the FIRPTA nonrecognition override provisions. Refer to the examples in Treasury Regulation §1.897-5T(b)(3)(iv)(B), §1.897-5T(c)(4) and §1.897-6T.

Since the FIRPTA nonrecognition override provisions are not applicable for California purposes, a foreign corporation does not benefit from the "i" election for California purposes. However, under the IRC provisions, a foreign corporation which has made the election is considered a USRPHC (and thus a USRPI). They will also be considered a USRPI for California purposes. Any gain recognized under California law on the disposition of such stock is therefore subject to inclusion in the water's-edge combined report.

3. Withholding Requirement

Every transferee of a USRPI is required to deduct and withhold a tax of 10 percent of the amount realized by the foreign transferor on the disposition.[94] The transferee is obligated to withhold even if the transaction will not generate taxable gain to the transferor. The transferor of the USRPI is required to file a return and pay whatever tax may still be due, using the withheld amount as a credit (as compared to the filing exemption granted to a foreign corporation if its only income is FDAP income and any tax due has been fully withheld at source).[95]

California has a very similar withholding requirement. The assessment and collection of the California withholding tax is handled by the Withhold at Source Unit in Operations Division in Sacramento. The presence of a federal or state withholding certificate within the California return may evidence the presence of a sale or exchange subject to IRC §897 includible in the water's-edge combined report as ECI.

f. IRC §883 Exclusions From Gross Income

IRC §883 provides that certain items of income of a foreign corporation are not included in gross income and are exempt from U.S. tax. CCR §25110(d)(2)(G) provides that income excluded from U.S. federal income tax pursuant to the provisions of IRC §883 will also be excluded from income in a water's-edge combined report. The IRC §883 exclusion applies to the following types of income:

1. Income from the international operation of ships and aircraft by foreign corporations, if the country in which the corporation is organized grants an equivalent exemption to U.S. corporations.[96] Revenue Ruling 89-42[97] provides a listing of countries that provide an equivalent exemption. Revenue Ruling 91-12[98] provides guidance on how to claim the exemption under IRC §883.The exemption does not apply to any foreign corporation if 50 percent or more of its stock is owned by individuals who are not residents of a foreign country meeting the equivalent exemption requirement. Attribution rules apply in determining if the 50 percent rule is met. The 50 percent rule does not apply to corporations whose stock is publicly traded in the U.S. or in a foreign country which meets the equivalent exemption. Finally, the exemption does not apply to any controlled foreign corporation as that term is defined for Subpart F purposes.[99]

2. Income from payments by a common carrier for the temporary use, not expected to exceed 90 days in any one year, of railroad rolling stock owned by a foreign corporation if the country in which the corporation is organized grants an equivalent exemption to U.S. corporations.[100]

3. Income derived from the ownership or operation of a communications satellite system by a foreign entity designated by a foreign government to participate in such ownership or operation is exempt if the U.S. participates in the system pursuant to the Communications Satellite Act of 1962.[101]

Note that the federal method of exempting such income is distinctly different from the manner in which California applies a similar exemption set forth in R&TC §24320. R&TC §24320 provides that income derived from the operation of aircraft or ships by a corporation organized under the laws of a foreign country is not included in gross income and is exempt from California tax if:

- The aircraft are registered or the ships are documented under the laws of the foreign country,

- The income of the corporation is exempt from national income taxes by reason of a treaty or agreement between such foreign country and the U.S. which provides for an equivalent exemption to corporations organized in the U.S., and

- Units of government (other than at the national level) within such foreign country do not impose a tax upon corporations organized in the U.S. with respect to income derived from the operation of aircraft registered or ships documented under the laws of the U.S.

California effects the R&TC §24320 exemption by including the income and only the denominators of the carrier in the combined report (to the extent such income and factors relate to the operation of aircraft or ships). In contrast, for federal purposes, such income is simply not included in the computation of the foreign corporation's gross income. In addition, under R&TC §24320 the exemption only applies if the aircraft/ship is documented under the laws of the foreign country and the entity is incorporated under the laws of the foreign country. Federal law only requires incorporation in the foreign country that grants the exemption.[102] R&TC Section 24320 also differs from IRC §883 in that it does not contain the "anti-treaty shopping" requirement that 50 percent or more of the foreign corporation's shareholders must be residents of the foreign country.[103]

For purposes of determining the amount of ECI of a foreign bank/corporation which is subject to inclusion in the water's-edge combined report, the federal rules for determining what income qualifies for the exemption and the federal method of excluding IRC §883 income from the gross income computation will apply. In other words, none of the income nor any of the related factors are includible in the water's-edge combined report, if the requirements of IRC §883 are met.

g. Summary

This section, discussed the concept of ECI. The next section will cover U.S.-source income, which is not effectively connected with a U.S. trade or business, including FDAP income. The succeeding chapter will discuss the manner of allocating expenses to determine the amount of net income includible in the water's-edge combined report.

1. The IRC does not specify which activities a foreign corporation must be engaged in to be considered engaged in a U.S. trade or business. The courts have generally looked to whether the corporation is engaged in substantial, regular, or continuous activities in the U.S.

2. Foreign corporations incorporated in a tax treaty country must generally have a "permanent establishment" in the U.S. before any of their U.S.-source income will be considered ECI.

3. Once it has been determined that a foreign corporation is engaged in a U.S. trade or business, or has a permanent establishment if it is from a tax treaty country, it is subject to tax on its ECI. FDAP income is taxable regardless of whether the foreign bank or corporation has a U.S. trade or business or permanent establishment.

4. ECI can be U.S. source or foreign source. However, for foreign-source income to be considered effectively connected, it must be attributable to an office or other fixed place of business in the U.S.

5. TreasReg §1.864-4 contains the rules for determining U.S.-source income.

6. TreasReg §1.864-5 contains the rules for determining foreign-source income.

7. Gain from the disposition of a USRPI is always treated as ECI regardless of whether the taxpayer is actually engaged in a U.S. trade or business.

8. Income from the international operation of ships and aircraft are excluded from gross income if the deemed subsidiary is incorporated in a country that grants an equivalent exemption to U.S. corporations.

9. The ECI from more than one business activity would be included in the same California combined report computation only if the activities are unitary.

Footnotes

1. IRC §864(b)
2. IRC §864(b)(1)
3. For purposes of this discussion, the term "securities" means any note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing. Effecting transactions in stocks or securities includes buying, selling, or trading in stocks, securities, or contracts or options to buy or sell stocks or securities, on margin or otherwise, for the account and risk of the taxpayer. TreasRegs. §1.864-2(c)(2)(c).
4. IRC §864(b)(2)
5. TreasRegs. §1.864-2(c)(1)
6. TreasRegs. §1.864-2(c)(2)(iii)
7. See footnote 5, supra
8. TC Memo 1996-301, Tax Ct. Rep. Dec. 51,428 (M) CCH, at 3231.
9. IRC 864(b)(2)(C)
10. de Amodio vs. Commissioner, 34 TC 894 (1960); Commissioner vs. Piedras Negras Broadcasting Co., 127 F.2d 260 (5th Cir.)(1942); Berliner Handels-Gesellschaft vs. U.S., 30 F. Supp. 490 (Ct. Cl. 1939);Jan Casimir Lewenhaupt, 20 TC 151 (1953); Revenue Ruling 56-165, 1956-1 CB 849; Revenue Ruling 76-161, 1976-1 CB 193.
11. Donroy Ltd. vs. United States, 301 F. 2d 200 (9th Cir 1962).
12. U.S. vs. Balanovski, 236 Fd 298.
13. Helvering vs. Boekman, 107 F2d 388 (1939). In addition, refer to Taisei Fire and Marine Insurance Co., Ltd., 104 TC 27 (1995), for a discussion of when an agent will create a permanent establishment in the U.S. on behalf of its principal.
14. Revenue Ruling 70-424, CB 1970-2 150
15. IRC §882(d)
16. TreasRegs. §1.871-10(b)(1)
17. TreasRegs. §1.871-10(d)(1)(ii)
18. IRC §864(c)(3) and TreasRegs. §1.864-4(b), Example (3).
19. IRC §864(c)(6)
20. IRC §864(c)(7)
21. CCR §25110(d)(2)(G)(ii)(I)
22. CCR §25110(d)(2)(G)(i)(I)
23. Cumulative Bulletins are currently available in the FEDTAX library in the CB file.

24. Rufus von Thulen Rhoades and Marshall J. Langer, (Mathew Bender, 1995).
25. Tax Management International Journal, Vol. 28, No. 3, March 12, 1999, page 152.
26. Revenue Ruling 80-223, 1980-2 CB 217.
27. P.L. 96-499 1125(c)
28. P.L. 100-647 1012(aa)(2) and (3)
29. S. Rep No 100-445, 100th Congress, 2d Session
30. Consolidated Premium Iron Ores Ltd., 59-1 USTC 9387; Revenue Ruling 67-321, 1967-2 CB 470; Revenue Ruling 67-322, 1967-2 CB 469.
31. Jules Samann, 63-2 USTC 9254; Georges Simenon, 44 TC 820; IRC §864(c)(6)
32. IRC §6114
33. CCR §25110(d)(2)(G)(i)(I)
34. Ibid.
35. TreasRegs. §1.864-4(c)(1)(i).
36. TreasRegs. §1.864-4(c)(4)
37. TreasRegs. §1.864-4(c)(2)(i)
38. TreasRegs. §1.864-4(c)(2)(iii)(a)
39. TreasRegs. 1.864-4(c)(2)(iii)(a) and TreasRegs. 1.864-4(c)(3)(i)
40. TreasRegs. §1.864-4(c)(2)(iii)(b)
41. TreasRegs. §1.864-4(c)(2)(v), Example 1
42. TreasRegs. §1.864-4(c)(2)(v), Example 5
43. TreasRegs. §1.864-4(c)(3)
44. TreasRegs. §1.864-4(c)(3)(ii), Example 2
45. TreasRegs. §1.864-4(c)(5)(vi)(b)
46. TreasRegs. §1.864-4(c)(5)(i)
47. TreasRegs. §1.864-4(c)(5)(i)
48. TreasRegs. §1.864-4(c)(5)(ii)
49. TreasRegs. §1.864-4(c)(5)(ii)(a)
50. TreasRegs. §1.864-4(c)(5)(ii)(b)
51. TreasRegs. §1.864-4(c)(5)(iv)
52. TreasRegs. §1.864-4(c)(5)(v)
53. TreasRegs. §1.864-4(c)(5iii)(a)
54. TreasRegs. §1.864-4(c)(5)(iii)
55. TreasRegs. §1.864-4(c)(5)(vii), Example 1
56. TreasRegs. §1.864-4(c)(5)(vii), Example 5
57. CCR §25110(d)(2)(i)(I)
58. TreasRegs. §1.864-5(b)(1)

59. TreasRegs. §1.864-5(b)(2)
60. TreasRegs. §1.864-5(b)(3)
61. IRC §864(c)(4)(A)
62. IRC §864(c)(4)(D)
63. TreasRegs. §1.864-6(b)(3)(i)
64. TreasRegs. §1.864-7
65. TreasRegs. §1.864-7(a)(2)
66. TreasRegs. §1.864-7(a)(3)
67. TreasRegs. §1.864-7(b)(2)
68. TreasRegs. §1.864-7(c)
69. TreasRegs. §1.864-7(d)(1) and IRC §864(c)(5)
70. A U.S. subsidiary of a foreign corporation was found to be a dependent agent in causing the foreign corporation to have a U.S. office in InverWorld, Inc., v. Commissioner, TC Memo 1996-301, Tax Ct. Rep. Dec. 51,428 (M) CCH, at 3231.
71. TreasRegs. 1.864-7(d)(2)
72. 104 TC 27 (1995)
73. TreasRegs. §1.864-7(e)
74. TreasRegs. §1.864-6(b)(1)
75. TreasRegs. 1.864-6(c)(2)
76. TreasRegs. §1.864-6(b)
77. TreasRegs. §1.864-6(b)(2)
78. TreasRegs. §1.864-6(b)(2)(i) Example 1
79. IRC §897(a)(1)
80. CCR §25110(d)(2)(G)(i)
81. TreasRegs. §1.897-1(g)
82. TreasRegs. §1.897-5T(b)(2)
83. IRC §897(d)(1)
84. IRC §897(d)(2) and TreasRegs. §1.897-5T(c)
85. TreasRegs. §1.897-5T(d)(1)(iii)
86. IRC §897(j)
87. TreasRegs. §1.897-5T(c)(3)(i)
88. TreasRegs. §1.897-5T(c)(4)(i)
89. TreasRegs. §1.897-5T(c)(4)(iii)
90. TreasRegs. §1.897-6T(a)(4)
91. TreasRegs. §1.897-3(b)
92. IRC §897(i), TreasRegs. §1.897-3(b) & §1.897-8T
93. TreasRegs. §1.897-3(a)
94. IRC §1445; TreasReg §1.1445-1(b)(1)

95. IRC §897(i); TreasRegs. §1.897-3(b) & §1.897-8T
96. IRC §883(a)(1&2)
97. 1989-1 CB 234.
98. 1991-1 CB 473.
99. IRC §883(c)
100. IRC §883(a)(3)
101. IRC §883(b)
102. The California documentation requirement is a hold-over from pre-1986 federal. California has never amended §24320 to conform to the 1986 Tax Reform Act changes to IRC §883.
103. IRC §883(c)(1)

Section 8.6 U.S.-Source - Non-Effectively Connected Income

Contents:

Training Objectives:

Section 8.4, Water's-Edge Manual discussed the federal rules for determining whether income was from U.S. or foreign sources. Once it has been determined that a foreign bank or corporation has U.S.-source income, the next step is determine what income, if any, is considered effectively connected with the conduct of a U.S. trade or business. Any income that is considered effectively connected with a U.S. trade or business is subject to taxation under the federal rules discussed in Section 8.5, Water's-Edge Manual. Other U.S.-source income that is not considered effectively connected with a U.S. trade or business is either subject to U.S. taxation as FDAP income or is neither ECI nor FDAP income and is not taxed for federal purposes. This section will discuss the U.S.-source non-effectively connected income rules, and the application of those rules for California. For income years beginning on or after January 1, 1992, all business U.S.-source non-effectively connected income is also includible in the water's-

edge combined report. Nonbusiness U.S.-source non-effectively connected income is excluded from the water's-edge combined report for all income years.

At the end of this section, you will be able to determine:

1. What income is from U.S. sources;
2. What U.S.-source income is taxed as FDAP; and
3. Whether U.S.-source income not effectively connected with a U.S. trade or business is considered business income includible in the water's-edge combined report.

a. Source Of Income

As discussed in detail in Section 8.4, Water's-Edge Manual, for federal tax purposes, income of a foreign bank or corporation is classified as either from U.S. or foreign sources. You must first determine the type of receipt involved (i.e., rent vs. service income, rent vs. royalty, interest, dividend, etc.,). Once an item of income is appropriately classified, you must then determine the source of income for federal purposes. The federal rules for sourcing income are significantly different that California's sourcing rules, but are followed solely for the purpose of determining whether an item of income is from U.S. sources, and whether it is considered ECI or not.

The general rules for sourcing each type of income for federal purposes are as follows:

1. Interest income - sourced to the residence of the debtor.
2. Dividend income - sourced to the country in which the payer is incorporated.
3. Personal services income - sourced to the location where the services were performed.
4. Rents and royalties - sourced to the location where the underlying property is used or usable.
5. Income from the disposition of real property - sourced where the property is located.
6. Income from the disposition of personal property - sourced at the residence of the seller.

There are many exceptions to the above general rules> A more detailed discussion on how to source income for federal purposes is located in Section 8.4, Water's-Edge Manual.

b. U.S.-Source Income Not Effectively Connected With A U.S. Trade Or Business

Once it has been determined that a foreign bank or corporation has income from U.S. sources, a determination must then be made as to whether the foreign corporation is engaged in a U.S. trade or business.

To the extent any of the income is determined to be effectively connected with the conduct of a U.S. trade or business, it is taxed under IRC §882 at the same progressive tax rates as domestic corporations on such income. To the extent a foreign bank or corporation is not engaged in a U.S. trade or business, or to the extent any item of income of a foreign bank or corporation is not considered effectively connected with a U.S. trade or business, the foreign bank or corporation's remaining U.S.-source income is generally subject to U.S. taxation under IRC §881.[1] Any U.S.-source income that is considered neither ECI nor FDAP income is not taxed for federal purposes.

The question of whether passive income is effectively connected with a U.S. trade or business is similar in concept to the question of whether income is business or nonbusiness. There are, however, some differences between the federal tests used to determine whether passive income is effectively connected with a U.S. trade or business, and California's tests used to determine if income is business or nonbusiness. The primary difference is that the federal tests look to whether the asset, which generated the income, is held to meet the present needs of the business. An asset held to meet anticipated future needs, such as business expansion or plant replacement, is generally not considered related to the U.S. trade or business. The federal rules regarding the determination of what passive income, if any, is effectively connected to a U.S. trade or business are discussed in greater detail in Section 8.5, Water's-Edge Manual.

1. FDAP - In General

IRC §881(a) imposes a flat withholding tax of 30 percent (or a lower tax treaty rate if applicable) on certain gross income from U.S. sources received by a foreign corporation. To be taxable under IRC §881, the U.S.-source income received must meet the following criteria:

A. The amount received must be described in IRC §881(a) and the regulations thereunder.

B. The amount received must constitute gross income under the IRC. In other words, receipts that are excluded from gross income under the IRC are not taxable under IRC §881. For example, state and local bond interest excluded from gross income under IRC §103 would not be taxable to a foreign corporation.

C. The amount received must be derived from U.S. sources.

D. The amount received must not be effectively connected with the conduct of a trade or business in the U.S. Income effectively connected with a U.S. trade or business is taxed under IRC §882 rather than IRC §881.

E. The amount received must not be exempted from the 30 percent withholding tax under the IRC.

2. Types Of FDAP Income

The types of income that IRC §881 applies to are referred to as "fixed or determinable annual or periodical (FDAP)" income. Specifically included by the IRC in the definition of FDAP is:

A. Interest Income

The IRC provides that if interest income from U.S. sources is not effectively connected with the conduct of a U.S. trade or business, then it is FDAP income subject to the flat withholding tax on gross income.[2] Original issue discount (OID) is excluded from this definition of FDAP income. However, certain OID is subject to the flat withholding tax under a separate provision of the IRC upon the sale or exchange of the OID obligation.[3] Interest includes interest on certain deferred payments as provided in IRC §483 and the regulations thereunder.[4]

B. Dividend Income

Dividend income from U.S. sources that is not effectively connected with a U.S. trade or business is FDAP income. A dividend is a distribution of current or accumulated earnings and profits. It is important to note that the withholding tax is paid on the gross amount received by the foreign bank or corporation. A dividend would include any money received plus the FMV of other property, but would not include any return of capital.

C. Miscellaneous Income

The IRC and regulations specify various types of income to be FDAP, including rents, royalties, salesmen commissions, salaries, wages, premiums, annuities, compensations, remunerations, and emoluments.[5] Other types of income can constitute FDAP income as well, such as income from an estate or trust in the U.S., which is required to be currently distributed; taxes; mortgage interest; or insurance premiums paid to or for the account of a nonresident alien landlord by a tenant pursuant to the terms of the lease.[6]

D. IRC Section 631 Gains

Gains described in IRC §631(b) and §631(c), from the sale of timber, coal, and iron ore, which was held for more than one year and in which the owner retains an economic interest, is FDAP income subject to the flat withholding tax of 30 percent.[7]

E. Original Issue Discount

Certain OID received on the sale or exchange of bonds or other evidences of indebtedness is also FDAP income. OID is defined in IRC §1273(a) as the excess of the stated redemption price over the price at which the bond or other evidence of indebtedness was originally sold. The amount taxable to the foreign corporation as FDAP income is:

- in the case of a payment on an OID obligation, the amount of the OID accrued on the obligation while the foreign corporation held the obligation that has not previously been subject to tax;[8] and

- in the case of a sale or exchange of an OID obligation, the amount of the OID accrued while the foreign corporation held the obligation, but only to the extent that the foreign corporation has not previously recognized the OID in income.[9]

F. Gains From The Sale Of Intangible Personal Property

Gains realized by a foreign bank or corporation from the sale or exchange of patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like property, or of any interest in such property, is FDAP income subject to the flat withholding tax under IRC §881, to the extent such gains are from payments which are contingent on the productivity, use, or disposition of the property or interest sold or exchanged. For such income to be considered FDAP income, it must not be effectively connected with the conduct of a U.S. trade or business.[10]

In determining the federal withholding tax on FDAP income, no deductions are allowed in determining the foreign bank or corporation's tax liability. In many instances, if the foreign bank or corporation is from a treaty country, the withholding tax is reduced to the (lower) applicable tax treaty.[11]

The payer of the income is the designated withholding agent for the foreign entity, and is required to withhold the tax from the payments made to the foreign entity. For federal purposes, the withholding agent will file federal Form 1042 reporting the amount of gross income paid, the amount of taxes withheld, and the number of federal Forms 1042-S filed. Federal Form 1042-S is provided to the income recipient and will reflect the type and gross amount of income received, and the name of the payer. Federal Form 1042-S should be attached to any federal tax return filed by the income recipient (federal Form 1120F).

3. Income That Is Not FDAP

Unless noted above in items A-F, FDAP does not include gains realized from the sale or other disposition of real or personal property.[12] However, any interest income received from an installment obligation from the gain on the sale of real or personal property that is not otherwise subject to U.S. tax would be taxed as FDAP interest under IRC §881(a). In addition, the following items have been held not to constitute FDAP income:

- Income from hedging transactions.[13]
- "Boot" dividends received as part of a corporate reorganization.[14]
- Capital gains dividends received from a regulated investment company.[15]
- Premiums for the insurance of U.S. risks by a foreign insurer.[16]
- Return of capital.

To the extent a corporate payer is unable to distinguish between a payment, which is a dividend distribution or a return of capital, the entire distribution remains subject to withholding. The payee can request a refund for any overpayment.[17]

c. Exception From Withholding For Certain Guam And Virgin Islands Corporations

A corporation created or organized in Guam, American Samoa, the Northern Mariana Islands, or the Virgin Islands, or created or organized under the law of any such U.S. possession will not be treated as a foreign corporation and will not be subject to U.S. withholding tax for any taxable year if:

- less than 25 percent of the value of the stock is beneficially owned by foreign persons;

- at least 65 percent of the gross income of the corporation is effectively connected with the conduct of a trade or business in the possession or the U.S. for the 3-year period ending with the close of the taxable year of such corporation; and

- no substantial part of the income of the corporation is used to satisfy obligations to persons who are not bona fide residents of the possession or the U.S. [18]

If the foreign corporation was not in existence during a portion of the three-year test period, then the test period will be limited to the portion of the three-year period that the foreign corporation was in existence.

d. Income Exempt From Withholding

1. Portfolio Interest

For obligations issued after July 18, 1984, certain U.S.-source "portfolio" interest received by foreign banks or corporations, which is not effectively connected with the conduct of a U.S. trade or business, is exempt from the withholding tax imposed by IRC §881. Portfolio interest means any interest, including OID, which would otherwise be considered FDAP income except for this exemption, and which is one of the following:

A. Interest paid on unregistered obligations described in IRC §163(f)(2)(B); or

B. Interest paid on registered obligations with respect to which the U.S. withholding agent has received a statement that the beneficial owner of the obligation is not a U.S. person.[19]

Qualifying portfolio debt may be in either registered or bearer form. In general, qualifying obligations must meet the following standards:

A. BEARER OBLIGATIONS

A bearer obligation must be "foreign targeted." A foreign targeted obligation is one that is sold under arrangements designed to ensure that the obligations will be originally issued to a foreign person,[20] provides that interest on the obligation is payable only outside the U.S., and is issued after July 18, 1984. A bearer obligation is a bond, debenture, promissory note, or other similar instrument which belongs to the person who has possession.

B. REGISTERED OBLIGATIONS

Registered obligations must be issued after July 18, 1984, and must either: 1) be targeted to foreign markets, or 2) if not targeted to foreign markets, the withholding agent (payer) must get a statement from the owner of the obligations signed under penalty of perjury that certifies that the owner is not a U.S. person. The statement must give the owner's full name and address.[21]

Registered obligations are instruments registered with the issuer so that they can be transferred only by surrender of the old instrument to the new holder or issuance of a new instrument to the new holder or instruments, which may only be transferred through a book entry system maintained by the issuer.[22]

Portfolio interest does not include:

a) Any interest paid on an obligation to any person who owns ten percent or more of the total combined voting power of all classes of voting stock of the corporation, or ten percent or more of the capital or profits interests in the partnership.[23]

b) Any interest paid to a controlled foreign corporation (CFC) by a related person.[24] Interest received by a CFC from an unrelated person may be eligible for exemption from the withholding tax paid by the CFC, but the interest will be includible in the income of the U.S. shareholders under IRC §951 without regard to the de minimis rule in IRC §954(b)(3), the high tax exception in IRC §954(b), or the exception from foreign personal holding company income for interest received from certain related persons. CFC has the same meaning as that found in IRC §957(a).

c) Certain contingent interest received by a foreign bank or corporation after December 31, 1993.[25] Contingent interest is defined in IRC §871(h)(4) as any interest which is determined by reference to:
   i) the sales, receipts, or other cash flow of the debtor or a related person;
   ii) any income or profits of the debtor or a related person;
   iii) any change in the value of property of the debtor or related person; or
   iv) any dividend, partnership distribution, or similar payment made by the debtor or a related person.

Refer to Notice 94-39[26] for more information on the contingent interest exception to the portfolio interest withholding tax exemption.

2. Other Interest And Dividends

An exemption from federal withholding tax is also provided for the following:

- Interests on deposits, if the interest is not effectively connected to the conduct of a U.S. trade or business;[27]

- A percentage of any dividend paid by a domestic corporation, if at least 80 percent of its gross income is foreign-source income earned from the active conduct of a trade or business in a foreign country or possession.[28] The exempt percentage is the ratio of foreign-source gross income during the testing period to total gross income during the testing period.[29] The testing period is the three-year period ending with the close of the taxable year of the corporation preceding the payment.[30]

- Income derived by a foreign central bank of issue from bankers acceptance.[31]

For purposes of this discussion, the term deposits means amounts which are deposits with persons carrying on a banking business, deposits with savings institutions chartered as savings and loans or similar associations under federal or state law, and amounts held by an insurance company under an agreement to pay interest thereon.[32]

e. Business U.S.-Source Income Not Effectively Connected To A U.S. Trade Or Business

For income years beginning on or after January 1, 1992, U.S.-source income not effectively connected with a U.S. trade or business is included in the water's-edge combined report in addition to ECI.[33] This would include all U.S.-source income regardless of whether it is exempt from federal withholding tax or not, including U.S.-source exempt interest income.[34]

The determination of whether U.S.-source income is business income is made under R&TC §25120(a). Business income includes income arising from transactions and activities in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business. Nonbusiness income is all income other than business income.[35] The R&TC §25120 definition of business income has been interpreted through case law as providing two alternative tests for determining whether income constitutes business income: the "transactional test" and the "functional test."[36] Since nonbusiness income is defined as all income that isn't business income, income that does not meet either one of the tests will be characterized as nonbusiness.

1. Transactional Test

Under the transactional test, any income resulting from any transaction or activity occurring in the regular course of the taxpayer's trade or business is business income.

Example 1:

A foreign corporation involved in the trade or business of owning and operating real property receives rental income from U.S. real property. Under the transactional test, the rental income would be business income. Note, however, that the foreign corporation's activities in the U.S. may not rise to the level of a trade or business (or a permanent establishment in the case of a foreign corporation from a tax treaty country). Accordingly, unless the corporation makes an election under IRC §882(d) to treat the income as ECI, the rental

income would not constitute ECI for federal purposes, but it would constitute FDAP income subject to tax on gross receipts.

2. Functional Test

The functional test provides for business treatment of income that is integrally related to the taxpayer's trade or business, but that arises from occasional or extraordinary transactions. Under the functional test, all income from property is considered business income if the acquisition, management and disposition of the property was an integral part of the taxpayer's regular business operations.

Example 2:

ACME corporation, a foreign corporation, manufactures women's clothing in Korea. ACME has a branch in the U.S. through which it sells women's clothing in the U.S. ACME intends to build a manufacturing facility in California in 1999. Accordingly, ACME established a sinking fund with a U.S. bank to pay for this planned expansion. During 1995, ACME deposited $20,000,000 in excess working capital in the sinking fund. ACME received $1,500,000 of interest income from this investment during 1995. Because the funds generating the interest income are to be used for future business expansion and not the present needs of the business, the interest earned thereon does not constitute ECI.[37] However, this income would constitute business U.S.-source income under the functional test.

For more information on business/nonbusiness income, refer to MATM 4000.

3. Techniques For Identifying Business/Nonbusiness Issues

Specific techniques for identifying business/nonbusiness issues will vary for various types of income. The hardest part will be identifying foreign banks and corporations with U.S.-source income. In general, the auditor can often spot potential U.S.-source income issues from reviewing the following:

- Federal Form 1120F filed by the foreign bank or corporation;
- Federal Form 8833, Treaty-Based Return Position Disclosure, filed by the foreign bank or corporation and attached to federal Form 1120F.
- Federal Forms 1042 and 1042-S filed by the payer reporting payments by a U.S. payer to a foreign bank or corporation.
- Federal Form 5472 filed by the U.S. bank or corporation reporting transactions between the U.S. corporation and either the foreign parent corporation or a foreign related party.
- Federal Form 5471 reporting transactions between a U.S. bank or corporation and a foreign subsidiary.

Any U.S.-source income so identified must then be classified as either business or nonbusiness income under either the transactional or functional test. All business U.S.-source noneffectively connected income would be included in the water's-edge combined report for income years beginning on or after January 1, 1992.

f. Reclassifying U.S.-Source Income

Business U.S.-source income is included in the water's-edge combined report for income years beginning on or after January 1, 1992. For income years beginning prior to this date, it is important for the auditor to be able to determine if income has been properly classified as either ECI or non-ECI income since only ECI is included in the combined report for those years. For example, although effectively connected interest income is subject to tax at progressive rates, most FDAP interest income is exempt from U.S. tax. Accordingly, taxpayers may be tempted to classify passive investment interest income as non-ECI income to obtain tax-free treatment. When examining a federal Form 1120F for an income year beginning prior to January 1, 1992, the auditor should question whether certain types of passive income (e.g., interest, dividends, and royalties, etc.,) reported as FDAP should have been reported as ECI instead. If reclassification is required, the ECI would be included in the water's-edge combined report.

Reclassification of U.S.-source income isn't as significant an issue for income years beginning on or after January 1, 1992. Both ECI and business non-ECI U.S.-source income are included in the water's-edge combined report. Accordingly, any reclassification of income will generally have no tax implications. However, reclassification of ECI as U.S.-source non-ECI will be an issue where the income is determined to be nonbusiness income. Reclassification of ECI as nonbusiness income, U.S.-source non-ECI will cause exclusion of the income from the combined report. Similarly, reclassification of an effectively connected loss as nonbusiness, U.S.-source non-ECI will cause exclusion of the loss from the combined report.

g. Summary

Available federal statistics reflect than more that $70 billion in FDAP income was paid to foreign banks and corporations during 1991.[38] More than half of this $70 billion of FDAP income was exempt from withholding. The only major categories of taxable interest income earned by foreign corporations, other than effectively connected interest income, are interest received from a related party and certain interest received with respect to privately negotiated loans. Foreign banks/corporations received approximately 76% of this $70 billion. In most instances, the tax withheld on such amounts represented the final tax liability of such foreign entities. Accordingly, the foreign recipients were not required to file a federal Form 1120F because their tax liability was fully satisfied by withholding-at-source.

The issue of whether a foreign bank or corporation has business U.S.-source income can be a material examination issue in light of the $70 billion in FDAP payments made during 1991. This will obviously be a more prevalent issue for foreign banks than foreign corporations since foreign banks receive the majority of FDAP payments. Any unitary foreign affiliate (bank or corporation) with business U.S.-source income will be includible in the water's-edge combined report to the extent of its net business U.S.-source noneffectively connected income and apportionment factors regardless of whether this U.S.-source income was taxed for federal purposes.

This section discussed the concept of U.S.-source business income includible in the water's-edge combined report. The Section 8.7, Water's-Edge Manual, will cover the manner of allocating expenses to determine the amount of net ECI or net U.S.-source noneffectively connected business income includible in the water's-edge combined report.

To summarize:

- A foreign bank or corporation's income must be classified by type.

- Once a foreign bank or corporation's income is classified by type, it can then be sourced under the federal rules as income from either U.S. or foreign sources. A detailed discussion of the federal sourcing rules can be found in Section 8.4, Water's-Edge Manual.

- Once income of a foreign bank or corporation is determined to be from either U.S. or foreign sources, a determination must be made as to what income, if any, is effectively connected with the conduct of a U.S. trade or business. Income effectively connected with the conduct of a U.S. trade or business is determined using the rules found in Section 8.5, Water's-Edge Manual.

- For income years beginning on or after January 1, 1992, U.S.-source income that is not effectively connected with the conduct of a U.S. trade or business is includible in the water's-edge combined report if it is business income as defined in R&TC §25120(a). A discussion of business and nonbusiness income and issues, and the functional and transactional tests can be found in the Multistate Audit Technique Manual.

- Issues regarding the reclassification of U.S.-source income as ECI are more significant for income years beginning before January 1, 1992. However, examination issues may exist if U.S.-source effectively connected losses should be reclassified as U.S.-source, nonbusiness losses not effectively connected with the conduct of a U.S. trade or business.

Footnotes

1. TreasRegs. §1.881-1(b)
2. IRC §881(a)(1)
3. IRC §881(a)(3)
4. TreasRegs. §1.1441-2(a)(1)
5. TreasRegs. §1.1441-2(a)(1); TreasRegs. §1.1441-2(a)(2)
6. TreasRegs. §1.1441-2(a)(2)
7. IRC §881(a)(2)
8. IRC §881(a)(3)(B)
9. IRC §881(a)(3)(A)
10. IRC §881(a)(4)
11. IRC §881(a)
12. TreasRegs. §1.1441-2(a)(3); Kimball Glass Company vs. Commissioner, 9 TC 183 (1949), acq., 1947-2 CB 3.
13. Income Tax Ruling (I.T.) 3137, 1937 CB 164
14. Income Tax Ruling (I.T.) 3781, 1946-1 CB 119
15. Revenue Ruling 69-244, 1969-1 CB 215.
16. Revenue Ruling 80-222, 1980-2 CB 211; modified by Revenue Ruling 89-91, 1989-2 CB 129.
17. Revenue Ruling 72-87, 1972-1 CB 274.
18. IRC §881(b)(1)
19. IRC §881(c)(2)
20. For a discussion of circumstances which meet the "designed to ensure" foreign issuance requirement, see TreasRegs. §1.163-5(c)(2)(i).
21. TreasRegs. §1.103-8(a) (formerly Temporary TreasRegs. 5f.103-1(c)(1)).
22. Temporary TreasRegs. §35a.9999-5(b)
23. IRC §881(c)(3)(B)
24. IRC §881(c)(3)(C)
25. IRC §881(c)(4)
26. 1994-17 IRB 21
27. IRC §871(i)(2)(A)
28. IRC §871(i)(2)(B)
29. IRC §861(c)(2)(A)
30. IRC §861(c)(1)(C)
31. IRC §871(i)(2)(C)
32. IRC §881(d) and §871(i)(2)
33. CCR §25110(d)(2)(G)
34. Section 8.6(c), Water's-Edge Manual and Section 8.6(d), Water's-Edge

Manual discuss various types of income that are exempt from the §881 withholding tax.

35. R&TC §25120(d)
36. Appeal of CTS Keene, Inc., Cal. St. Bd. of Equal., 2/10/93; Appeal of DPF, Inc., Cal.St. Bd. of Equal., 10/28/80; Appeal of Borden, Inc., Cal. St. Bd. of Equal., 2/3/77.
37. TreasRegs. §1.864-4(c)(2)(iii)(a)
38. "Foreign Recipients of U.S. Income, 1991", Denise Bori, SOI Bulletin, page 34. Statistics for 1992, the first year for which the changes in CCR §25110(d)(2)(i)(I) are effective, were not available at the time this text was drafted.

Section 8.7 Allocation And Apportionment Of Deductions

Contents:

Training Objective

The rules for determining the source of certain income items, and the rules for determining whether those income items are either effectively connected with a U.S. trade or business or U.S.-source noneffectively connected business income were discussed in the previous three sections. The next step in the process of calculating taxable income includible in the water's-edge combined report is to determine the allowable deductions against gross income. In this section, the federal rules used to determine the allocation and apportionment of deductions will be discussed.

At the end of this section, you will be able to determine:

1. The proper allocation and apportionment of expenses other than interest under the principles of Treasury Regulation §1.861-8.
2. The computation of interest expense under the principles of Treasury Regulation §1.882-5.

a. Introduction

1. In General

For California purposes, income of a deemed subsidiary included in the water's-edge combined report is determined under federal tax law.[1] In determining net income included in the water's-edge combined report, deductions attributable to includible U.S.-source income are determined using the allocation and apportionment rules set forth in Treasury Regulation §1.861-8 (for deductions other than interest expense) and §1.882-5 (for interest expense).[2] In determining net income of a deemed subsidiary, the deductions must be:

- Deductible under the IRC (and the RTC);
- Related to the income included in the water's-edge combined report; and
- Properly allocated to the income included in the water's-edge combined report.

Once income and expenses includible in the water's-edge combined report are determined using the federal rules, taxable income is then determined pursuant to the R&TC by making appropriate state adjustments.[3]

2. Federal Rules

A foreign corporation engaged in a trade or business in the U.S. is allowed deductions against its ECI in determining its federal taxable income.[4] For California purposes, a foreign bank or corporation is allowed deductions against its noneffectively connected U.S.-source business income as well.[5]

For federal purposes, a foreign corporation claiming deductions from gross income must furnish information sufficient to establish that the corporation is entitled to the claimed deductions. All information must be furnished in a manner suitable to permit verification of the claimed deductions. The IRS may require that an English translation be provided for any information that is presented in a foreign language. If a foreign corporation fails to furnish sufficient information the deductions may be disallowed in full or in part.[6]

For federal purposes, a foreign corporation can only receive the benefit of allowable deductions if it files a federal Form 1120F.[7] Furthermore, for taxable years ending after July 31, 1990, the foreign corporation can receive the benefit of deductions only if it timely files a return. In general, to be considered timely the return must be filed within 18 months of the statutory return due date set forth in IRC §6072. If a foreign bank or corporation believes that its activities are not sufficient to give rise to ECI, it may file a "protective" timely federal Form 1120F to preserve the right to receive the benefit of any allowable deductions in the event it is later determined that its activities are sufficient to give rise to ECI.[8] Such a "protective" return must be timely filed.

There is no provision in California law comparable to IRC §882(c) (and Treasury Regulation §1.882-4(a)(2)), which would similarly permit the permanent disallowance of deductions claimed by a foreign bank or corporation solely for failing to timely file a tax return. Accordingly, any deduction that would otherwise be allowable in computing California taxable income of a deemed subsidiary is deductible for California purposes regardless of whether a federal return is filed or the deductions were disallowed as a result of the application of IRC §882(c). Regardless, the burden of proof for substantiating allowable deductions still remains with the taxpayer.[9]

The rules for determining the allowable deductions attributable to U.S.-source income includible in the water's-edge combined report are found in Treasury Regulation §1.861-8 and §1.882-5.[10] The rules contained in Treasury Regulation §1.861-8 are applicable for purposes of determining the deductions other than interest expense which are to be taken into account in determining net U.S.-source income includible in the water's-edge combined report. Treasury Regulation §1.882-5 contains the rules for determining the interest expense deduction allowed in the California net income computation.

b. Allocation And Apportionment Of Deductions Other Than Interest Under Treasury Regulation §1.861-8

1. General Concept And Definitions

The general concept of Treasury Regulation §1.861-8 is that deductions should be related or attributed to the activity which produced the income. While that concept may seem relatively straight-forward, the regulation contains some novel terminology which must be understood in order to apply the principles set forth in the regulation. As briefly discussed in Chapter 6, Water's-Edge Manual, the determination of effectively connected deductions is accomplished by means of an "allocation and apportionment" system. Be sure to keep in mind that the federal allocation and apportionment concept bears absolutely no resemblance to the UDITPA concept for the same terms.

The basic rule for determining what deductions are related or attributed to the activity which produced the income requires deductions to be "allocated" to a "class of income." Once so "allocated" to a "class of income," the deduction is then "apportioned" between the "statutory" and "residual" groupings within the "class of income." The definitions of these federal terms are as follows.

A. Class Of Income

A class of gross income is the gross income to which a specific deduction is definitely related and may consist of one or more items of gross income enumerated in IRC §61 (e.g., gross business income, interest, rents, royalties, etc.).[11] For example, if the foreign corporation pays real property taxes, those taxes are definitely related to the income derived from the real property.

B. Statutory Groupings

A statutory grouping of gross income is gross income from a specific source or activity which must first be determined to arrive at taxable income from such specific source or activity.[12] For a foreign bank/corporation determining its net taxable ECI, the statutory grouping would be all of its gross income meeting the

ECI standard. For income years beginning prior to January 1, 1992, California would have this same statutory grouping since only ECI would be included in the water's-edge combined report. For income years beginning on or after January 1, 1992, the statutory groupings for California purposes would be all ECI and all business noneffectively connected U.S.-source income.

C. Residual Groupings

A residual grouping is gross income from all other sources or activities not included in the statutory grouping.[13] For a foreign bank or corporation, the residual grouping is gross income not effectively connected with a U.S. trade or business, e.g., foreign and U.S.-source noneffectively connected income. For income years beginning prior to January 1, 1992, California would have the same residual grouping as for federal purposes. However, for income years beginning on or after January 1, 1992, the residual grouping of gross income for California purposes would be noneffectively connected foreign-source income and nonbusiness noneffectively connected U.S.-source income.

D. Allocation

Allocation is the first step in what is generally a two-step process of determining allowable deductions. Deductions are first allocated to a class or classes of gross income to which they are definitely related.[14]

E. Apportionment

Apportionment is the second step in the process of determining allowable deductions. After the expenses definitely related to a class of income have been allocated to a class of income, they must be apportioned between the statutory grouping and the residual grouping within that class.[15] Deductions not definitely related to any gross income are apportioned to all gross income. Apportionment is accomplished by multiplying the deduction to be apportioned by some fractional component (e.g., units sold, gross receipts, gross sales, etc.,) of which:

- the numerator is comprised of the statutory or residual grouping component amount within the class of gross income that the deduction is allocated to, and

- the denominator is comprised of the total component amount (both statutory and residual) of the class of gross income to which the deduction is allocated.

Treasury Regulation §1.861-8(f)(1)(iv) provides that the rules of Treasury Regulation §1.861-8 are applicable for purposes of identifying the deductions from gross income which are allowable in determining taxable income.[16] However, the regulation provides minimal guidance for actually applying those rules to foreign banks and corporations. Both the taxpayer and the auditor are therefore faced with the task of trying to apply the general rules set forth below with limited guidance provided in the regulations.

2. General Rules For Allocation Of Deductions

The general rules for allocating expenses, losses, and other deductions (referred to collectively as deductions) separate such deductions into three basic categories:

- Deductions definitely related to a class of gross income;
- Deductions related to all gross income; and
- Deductions not definitely related to any gross income.[17]

As noted above, the allocation process is the first step in the two step process of applying the rules of Treasury Regulation §1.861-8. The apportionment process is the second step. The allocation process does not produce a mathematical division of the expense against various types of income. It merely establishes whether the expense is definitely related to a class of gross income.

A. Deductions Definitely Related To A Class Of Gross Income

If a specific deduction is definitely related to a specific type of gross income (such as rents, interest, etc.,) the income is referred to as a class of gross income. Classes of gross income are not predetermined (i.e., by reference to the income reported for year), but rather are determined on the basis of the deductions to be

allocated. Thus, the allocation process is accomplished by determining, with respect to each deduction, the class of gross income to which the deduction is definitely related and then allocating the deduction to that class. The allocation is made without regard to the taxable year in which gross income is received or accrued or is expected to be received or accrued.[18]

The determination of classes of gross income by reference to the deductions is essential because there may be deductions which are related to a class of gross income which the corporation did not recognize during the year. For example, property taxes may have been paid on an investment in real property for which no income was realized during the income year. The property taxes would still be considered definitely related to the income which is currently, or is expected to be, generated by the real property.

Exempt income is to be taken into account in the allocation process. In other words, expenses which are definitely related to exempt income are allocated to such income. The term exempt income means any income that is, in whole or in part, exempt, excluded, or eliminated from the income computation pursuant to the IRC and the R&TC. For example, exempt income would include dividends that are eliminated under R&TC §25106 or deducted under R&TC Sections 24402, 24410, or 24411.[19] Example 24 of Treasury Regulation §1.861-8T(g) demonstrates the application of the allocation process to exempt income.

Finally, note that in allocating deductions it is not necessary to differentiate between deductions related to one item of gross income and deductions related to another item of gross income if both items of gross income are exclusively within the same statutory grouping or exclusively within the residual grouping.[20]

B. Deductions Related To All Gross Income

If a deduction does not bear a definite relationship to any specific class of gross income, then the deduction will generally be treated as related and allocable to all gross income.[21] However, there are separate rules for allocating interest and research and development expense. Although the regulation uses the term allocable, in reality such deductions will be ratably apportioned between all gross income. (Be aware that the regulations have a tendency to inconsistently use the terms allocate and apportion).

C. Deductions Not Related To Any Gross Income

The regulations list various deductions that are considered not definitely related to any gross income and are therefore ratably apportioned to all gross income. The only listed deduction relevant to corporations is the charitable contribution deduction.[22] Such deductions are ratably apportioned between the statutory and residual groupings based on the ratio of gross income in the grouping to total gross income.[23]

D. Rules For Allocating Deductions Definitely Related To A Class Of Income

A deduction is considered definitely related to a class of gross income if it is incurred as a result of, incident to, or in connection with an activity or property from which the class of gross income is derived. In some cases, the definitely related test can be most readily applied by determining the categories of gross income to which a deduction is not related and concluding that it is definitely related to a class consisting of all other gross income.[24]

To establish the relationship between the deduction and a particular class of gross income, an analysis must be made of the functions underlying the deduction. Moreover, it is not sufficient to base this analysis on broad categories of deductions such as general and administrative expenses or on deductions such as officers' salaries or taxes because the general category of a deduction, such as salaries, may include items which are definitely related to a class of gross income, related to all gross income, or not definitely related to any gross income. Therefore, the specific items comprising such deductions must be reviewed and a determination made as to where such items should be allocated.

For example, consider the case of a foreign bank. The salary of the president (included in officers' salaries), the salary of his staff (included in other salaries), and the portion of the overhead expenses of the headquarters office (where the president is located) which are attributable to the president's office, are typically related to all classes of gross income. The salary of the vice president in charge of U.S. operations and the salaries of his staff and the overhead expenses attributable to his office are directly related to the income from banking activities earned by the U.S. branch. The salary of the staff in charge of reviewing requests for charitable contributions and the overhead expenses attributable to this function are not definitely related to any gross income and are therefore

ratably apportioned to all items of gross income. As this example demonstrates, it is important for the auditor to obtain organization charts, manuals, or other documentation, which detail the functions of the various organizational units, employees, and assets of the taxpayer to determine the proper allocation of expenses.

E. Allocating Deductions Related To Supportive Functions

Deductions which are supportive in nature (e.g., overhead, general and administrative costs, supervisory expenses, etc.,) may relate to other deductions which can more readily be allocated to a class of gross income. If this is the case, such supportive deductions may be allocated along with the deductions to which they relate. On the other hand, it is equally acceptable to allocate supportive deductions on some reasonable basis directly to all gross income or to another broad class of gross income. For this purpose, reasonable departmental overhead allocation rates may be utilized.[25]

Note that there is an important difference between supportive functions and so-called "stewardship" functions. Supportive functions are those that provide a direct benefit to the subsidiary/branch, while stewardship functions are overseeing functions undertaken for the corporation's own benefit as an investor in a related subsidiary. Deductions related to supportive functions are typically allocated to all classes of gross income. Deductions related to stewardship functions, on the other hand, are always considered definitely related to dividend income.[26] Stewardship expenses are discussed in more detail below.

F. Allocating Deductions Related To All Classes Of Gross Income

Deductions related to gross income that do not bear a definite relationship to a specific class of gross income are generally allocated to all gross income using a reasonable method, except as specifically provided otherwise in the regulations.[27]

G. Allocating Deductions Not Definitely Related To A Class Of Income

Deductions that are not definitely related to income are ratable apportioned to all gross income.[28]

3. General Rules For Apportionment Of Deductions

After all deductions have been appropriately allocated to the various classes of income, the next step is to apportion the deductions between the statutory grouping and residual grouping within each class of gross income. As noted previously, for purposes of determining the taxable ECI of foreign banks and corporations, the statutory grouping is all gross income meeting the ECI standard and the residual grouping is all other income. This would be the same for California purposes for income years beginning prior to January 1, 1992. For income years beginning on or after January 1, 1992, the statutory grouping would be all ECI and business noneffectively connected U.S.-source income, and the residual group would be all income of the foreign bank or corporation excluded from the water's-edge combined report for California purposes. For the apportionment process to come into play, a class of gross income, such as dividends, must contain both a statutory and residual grouping of income.

Example 1:

During 1996, Coupe Corporation, a foreign corporation, received dividend income from an equity investment in a U.S. corporation. The dividend income is considered effectively connected with Coupe's U.S. trade or business. Coupe incurred stewardship and other expenses related to the management of its equity investment in the U.S. corporation. Coupe did not receive any other dividend income. The stewardship and other expenses are allocable to the dividend income as deductions definitely related to a class of income (dividends). Since all of the dividend income is included in the water's-edge combined report, there is no need to apportion the deductions within the class of income because all of the income is in the statutory grouping.

The general rules for apportionment of deductions provide that the apportionment is to be based on the factual relationship between the deductions and the

statutory and residual groupings of gross income. In determining the method of apportionment for a specific deduction, factors which should be considered include, but are not limited to, the following:

- Comparison of units sold in the U.S. to units sold without the U.S.
- Comparison of the amount of gross receipts in the U.S. to gross receipts from without the U.S.
- Comparison of cost of goods sold in the U.S. to cost of goods sold outside the U.S.
- Comparison of the respective profit contribution made by each grouping.
- Comparison of expenses incurred, assets used, salaries paid, space utilized, and time spent which are attributable to the activities or properties generating the income.
- Comparison of the amount of gross income in the statutory and residual groupings.[29]

The method of apportionment must be one which "reflects to a reasonably close extent the factual relationship between the deduction and the groupings of gross income". For example, the gross income method would be inappropriate in cases where the deductions for the year are definitely related to a class of income and there is no gross income in that class.

Deductions not definitely related to any gross income (e.g., charitable contributions) must be apportioned ratably between the statutory grouping and the residual grouping on the basis of gross income within each grouping to total gross income.[30] Deductions related to all gross income, (e.g., supportive general and administrative expenses, etc.,) would similarly be apportioned ratably between the statutory and residual groupings using a method which reasonably reflects the relationship between the deduction and the groupings. Virtually all foreign banks and corporations engaged in a U.S. business will claim a deduction from ECI for "home office" supportive expenses.

A home office deduction represents a U.S. tax deduction for expenses incurred by the home office, which are attributable to the U.S. business operations. The administration of a multinational operation requires some degree of centralized management, which benefits the organization as a whole, and a reasonable portion of the total cost of such management services may be considered to be in support of the U.S. business activities. Typical expenses which might be considered supportive expenses include legal fees, training programs, and

international department expenses. Common methods of allocating home office expenses include the use of ratios of either: U.S. to worldwide assets; U.S. to worldwide income; or, ratios of time spent by pertinent employees on the U.S. operations to time spent by such employees on total operations. A tax planning priority of any foreign corporation is to maximize the apportionable expense pool to obtain an increased home office expense deduction.

Note that the regulations do not rule out the apportionment of expenses based on gross receipts or gross income as being a reasonable method. The gross receipts or income method may be used to apportion supportive expenses between the statutory grouping and residual grouping in cases where the facts would not justify a method on more specific factors.[31]

Finally, in contrast to the deduction allocation process, exempt income is not taken into account in apportioning deductions between the statutory and residual groupings.[32] Example 24 of Treasury Regulation §1.861-8T(g) demonstrates the application of this rule.

4. Rules For Allocating And Apportioning Specific Categories Of Deductions

The above discussion covered the general rules for allocating and apportioning deductions. To provide additional guidance, Treasury Regulation §1.861-8 also sets forth rules governing the allocation and apportionment of specific categories of deductions. Those categories are:

A. Interest expense-domestic corporations and CFC's[33]
B. Stewardship expenses[34]
C. Research and development expenses[35]
D. Legal and accounting fees and expenses[36]
E. Income taxes[37]
F. Losses on the sale, exchange, or other disposition of property[38]
G. NOL's[39]

Only categories B, C, D, F, and G are applicable for purposes of determining a foreign bank/corporation's taxable ECI includible in a water's-edge combined report. Category A, interest expense, generally only applies to domestic corporations (although, at the taxpayer's option, the rules may also be used to

determine the net income of a CFC. See Chapter 9, Water's-Edge Manual for more information.) Category E, income taxes, is not deductible for California purposes. The specific rules for Categories B, C, D, F, and G are discussed in more detail below.

A. Stewardship Expenses

Stewardship expenses, Category B, are defined as expenses related to activities which are considered not incurred for the benefit of a related corporation, but are considered to constitute overseeing functions undertaken for the corporation's own benefit as an investor in the related corporation. Stewardship activities are the activities of overseeing investments, such as investments in foreign and domestic subsidiaries. These activities or services do not directly benefit the subsidiaries. Therefore, the subsidiaries are not typically charged for these services. Stewardship services generally represent a duplication of services, which the related corporation has independently performed for itself. Stewardship services performed by the parent would include:

- Review by the parent corporation of an analysis prepared by the subsidiary of its borrowing needs.
- An internal audit by the parent corporation of the subsidiary's books.
- A periodic review of the subsidiary's financial policies by the parent corporation's treasurer.
- Review of a subsidiary's marketing plan to determine whether it is in conflict with the parent corporation's marketing strategy.

Stewardship services are limited to services performed by one affiliate in connection with supervising and protecting its investment in another affiliate. Stewardship expenses are considered definitely related to dividend income. Therefore, for allocation purposes, the expenses resulting from stewardship functions are considered incurred as a result of, or incident to, the ownership of the related corporation. Thus, they are allocable to dividends received or to be received from the related corporation.[40]

After stewardship expenses are allocated, they must be apportioned between the statutory and the residual grouping. As discussed above, the method of apportioning expenses must be based on the factual relationship between the deductions and the related income. Generally, an apportionment based on the

amount of dividends in the statutory and residual grouping is not appropriate because the dividend payment policies of the subsidiaries may bear no relationship to the stewardship expenses or the amount of income earned by each subsidiary.[41] The regulation provides that methods of apportionment which could be appropriate include comparisons of time spent by employees, weighted to take into account differences in compensation or comparisons of each related corporation's gross income, gross receipts, or unit sales volume.

Treasury Regulation §1.861-8(g), Examples 17–21, discuss the application of the allocation and apportionment rules to stewardship and supportive expenses. Refer to Treasury Regulation §1.861-8(e)(4) for more information.

B. Research And Development Expenses

A very brief overview and history of the rules for allocating and apportioning research and development (R&D) expenses, Category C, is set forth below. The rules are primarily relevant for domestic corporations for purposes of determining their foreign tax credit. Foreign corporations engaged in a U.S. trade or business are primarily comprised of banks, real estate investment ventures, and trading companies, which do not typically incur this type of expense. Thus, the R&D expense allocation and apportionment will not be covered in any great depth in this chapter. Anyone interested in a more detailed analysis of this issue should refer to Treasury Regulation §1.861-8(e)(3) and IRC §864(f).

The regulations covering the allocation and apportionment of R&D expenses are the most extensive found in Treasury Regulation §1.861-8. Congress has, however, repeatedly delayed implementing the regulation since 1981, primarily because they have been trying to decide how to best go about providing a tax incentive to conduct R&D in the U.S.

Since 1981, the rules in Treasury Regulation §1.861-8(e)(3) have been temporarily modified by eight legislative enactments. IRC §864(f) suspended the application of Treasury Regulation §1.861-8(e)(3) effective for the taxpayer's first two taxable years beginning after August 1, 1989, and for the first six months of a taxpayer's first taxable year beginning after August 1, 1991.[42] Revenue Procedure 92-56[43] further provided that a review of the regulation was being undertaken and effectively allowed taxpayers to elect to use the rules in IRC §864(f) instead of the rules found in Treasury Regulation §1.861-8(e)(3) for the

last six months of its first taxable years beginning after August 1, 1991, and for the immediately succeeding taxable year. The 1993 Revenue Reconciliation Act extended the application of IRC §864(f) to a taxpayer's first taxable year beginning before August 1, 1994, following the last taxable year of the taxpayer to which Revenue Procedure 92-56 applies or would have applied had the taxpayer elected the benefits of this revenue procedure. Absent another extension, it appears that Treasury Regulation §1.861-8(e)(3) would apply to taxable years beginning after this date.

Further complicating the issue here is a statement in the Committee Reports to the rules established by TAMRA and OBRA, which provides that IRC §864(f) and its predecessor rules suspending the application of Treasury Regulation §1.861-8(e)(3) do not apply for purposes of calculating ECI of a foreign taxpayer.[44] The Committee Reports are silent, however, with respect to exactly what rules would apply for purposes of calculating taxable ECI, and similar language is not used in subsequently issued Committee reports. As a result, it appears that the language in Treasury Regulation §1.882-4(b)(1) controls which rules apply by providing that the rules of Treasury Regulation §1.861-8 apply for purposes of determining deductions allocated and apportioned to gross ECI.

At a minimum, Treasury Regulation §1.861-8(e)(3) provides guidance for determining a reasonable method of allocating and apportioning R&D expenses of foreign corporations for federal purposes. For California purposes, these are the rules required to be used to determine the R&D deductions allowable in determining net income includible in the water's-edge combined report.[45] The following is a brief overview of the rules for allocating and apportioning research expenses using the method prescribed in Treasury Regulation §1.861-8(e)(3).

Step 1:

As a first step in allocating and apportioning R&D expenses, the bank or corporation must identify the broad product categories from which it derives gross income. (Treasury Regulation §1.861-8(e)(3) provides that the term R&D expenses refers to items deductible under IRC §174. Related expenses deductible under other IRC sections, or initially capitalized, would fall under the general rules for allocation and apportionment of general expenses.) The regulations recognize that R&D costs are ordinarily related to all income connected with the broad product category and therefore allocable to all items of gross income in the relevant product category, such as sales, royalties and

dividends. The regulations list the product categories to which income may be allocated. The regulations tie into the major two-digit classifications found in the Standard Industrial Classification (SIC) Manual, which identify 32 product categories.[46]

Step 2:

Once the product categories have been identified, the deductions for R&D are allocated to those categories as being definitely related to income reasonably connected to that category.[47] If the R&D cannot be clearly identified with any product category, the deduction will be allocated to all product categories.

Step 3:

Upon completion of the allocation process, R&D deductions must be apportioned between the statutory and residual groupings within the respective product category(ies). The regulations provide that R&D expenditures undertaken pursuant to a government directive are allocable to the income produced in the geographic region that benefited from the legal requirement, if the results of the R&D cannot reasonably be expected to generate income outside the geographic location where the R&D was incurred. For example, if the U.S. Food and Drug Administration required certain tests on products, and the test results cannot reasonably be expected to generate gross income outside the U.S., the costs of testing would be allocated to U.S.-source income.[48] This rule would similarly apply to product testing in a foreign country that could not reasonably be expected to generate gross income outside the foreign country. The costs of testing would be allocated to foreign-source income.

Once such government mandated expenses have been allocated and apportioned, the regulations provide three methods for apportioning the remaining R&D deductions as follows:

1. The Exclusive Apportionment Method

The exclusive apportionment method reflects the view that R&D activities are often most valuable in the location where the R&D was undertaken. The basic approach of this method is to generally apportion 30 percent of the R&D expenses to a class of income arising from the geographic source where most of the R&D activities were performed. The remaining 70 percent is apportioned

between the statutory and residual groups on the basis of sales from the relevant SIC product category in the relevant grouping to total sales in the relevant SIC product category. (The term product category is synonymous with the term class of income).[49]

This method must be used when more than 50 percent of the R&D activities for a particular SIC product category have been performed in a geographic area that is in either the statutory or residual grouping (i.e., more than 50 percent of the R&D was conducted in one country or area).

A taxpayer is permitted to apportion more than 30 percent of R&D expenses to the geographic area where the R&D was performed if it can demonstrate that the R&D has a very limited or long delayed application outside the geographic area where the R&D was performed.[50]

2. The Sales Method

The sales method apportions R&D expenses between the statutory and residual grouping based on sales within each relevant SIC product category(ies). It also utilizes a look through approach in which sales of the relevant SIC product category(ies) from uncontrolled and controlled parties must be taken into account together with the sales of the taxpayer if such parties can reasonably be expected to benefit from the R&D (for example, a licensee).[51]

3. The Optional Gross Income Method

Subject to limitations, a taxpayer may elect on an annual basis to apportion R&D deductions using one of two optional gross income methods instead of the sales method. By using the optional gross income methods, a taxpayer may significantly reduce the allocation of R&D expenses to the residual grouping thereby reducing U.S.-source income subject to tax. This method is structured as follows:

- Under option one, the taxpayer may apportion its R&D expenses ratably on the basis of gross income if the R&D apportioned to the statutory grouping and residual grouping is at least 50 percent of the R&D expense that would have been apportioned under the exclusive apportionment and sales method.[52]

- If option one cannot be used because one of the 50 percent tests is not satisfied, the taxpayer may elect under option two to apportion to a statutory or residual grouping a floor of 50 percent of the R&D expense that is apportionable to it under a combination of the exclusive apportionment and sales method.[53]

Examples (3)-(16) and Example (23) in Treasury Regulation §1.861-8(g) demonstrate how to allocate and apportion R&D expenses.

C. Legal And Accounting Fees And Expenses

The Treasury Regulations provide that fees and other expenses for legal and accounting services, Category D, are ordinarily definitely related and allocable to specific classes of gross income or to all gross income, depending on the nature of the services rendered.[54] Examples of services considered definitely related to specific classes of gross income are:

- Accounting fees incurred for the preparation of a study of costs involved in manufacturing a specific product would be definitely related to the class of gross income derived, or expected to be derived, from that product.

- Fees incurred in contesting a patent infringement suit would be definitely related to the class of gross income derived from the product covered by the patent.

After the legal and accounting fees have been allocated to a class of gross income, or to all gross income, they are apportioned between the statutory grouping and the residual grouping on the basis of the general rules for the apportionment of deductions found in Treasury Regulation §1.861-8T(c).

The regulation provides that the taxpayer will not be relieved from its responsibility to make a proper allocation and apportionment of fees on the grounds that:

- The statement of services rendered does not identify the services performed beyond a generalized designation such as "professional".

- The statement provided by the attorneys or accountants does not provide any type of allocation.

- The statement does not properly allocate the fees involved.

In other words, the taxpayer has the burden of documenting the specific nature of the services performed to enable the determination of whether the expenses definitely relate to a specific class of income.[55]

D. Losses On The Disposition Of Property

The deduction allowed for a loss recognized on the disposition of a capital asset or property, Category F, described in IRC §1231(b) is considered a deduction which is definitely related and allocable to the class of gross income which the property generates.

The Treasury Regulation approach is to trace the losses to income generated by the property that was the subject of the investment. They provide that when the nature of gross income generated by the asset has varied significantly over several years, the class of gross income for purposes of allocation should generally be determined by reference to gross income generated by the asset during the year, or the year(s) immediately preceding the sale or other disposition of the asset.[56]

The IRS has ruled, for example, that a bank that experiences a loss from a charge-off or disposition of an "eligible loan" (as defined in IRC §585(b)(4)), is to allocate that loss against the class of income into which the income from that loan would fall.[57]

E. NOLs

The basic approach of the Treasury Regulations for an NOL deduction is that it should be treated as a deduction, Category G, definitely related and allocable to the class of gross income to which the activity or property which generated the NOL gave rise or could reasonably have been expected to give rise.[58]

For apportionment purposes, the Treasury Regulations provide that the NOL deduction is to be apportioned between the statutory grouping and the residual grouping on the basis of the amount of the NOL attributable to the respective groupings of income in the year when the NOL arose.

5. Foreign Currency Rules

Chapter 12, Water's-Edge Manual discusses the concept of qualified business units (QBU) and the functional currency requirements. Briefly, IRC §989 provides that a QBU is any separate unit of a trade or business of a taxpayer, which maintains separate books and records. Pursuant to IRC §985, each QBU must determine its "functional currency" (generally the currency in which its business is primarily transacted), and use that currency to make all determinations required under the IRC. Non-functional currency amounts must be translated into the functional currency using the appropriate exchange rate. The appropriate exchange rate is generally the weighted average exchange rate for the year. The term "weighted average exchange rate" generally means the simple average of the daily exchange rates.[59]

A foreign corporation that has income that is effectively connected with, or treated as effectively connected with, the conduct of a U.S. trade or business is treated as a separate QBU with a dollar functional currency.[60] The U.S. branch income and expense amounts must, therefore, be stated in U.S. dollars. In all probability, the home office income and expense amounts will be stated in the foreign currency of the home office. Given this, the question arises as to how to go about allocating and apportioning the home office expenses to the U.S. trade or business.

In situations where you are apportioning the home office expenses using a method based on non-monetary factors, such as a comparison of units sold or employee time records, you would simply determine the appropriate apportionment ratio to apply to the home office expenses and convert the resulting apportioned expense to U.S. dollars. In situations where the method of apportionment is based on monetary amounts, such as a comparison of gross receipts, you would first have to convert the factors into a common currency to calculate the appropriate apportionment ratio.

6. Examples Of The Application Of Treasury Reg. §1.861-8 To Foreign Corporations

The following examples demonstrate the application of the Treasury Regulation §1.861-8 rules.

Example 2:

Alpha Corporation, a foreign corporation doing business in the U.S., is a manufacturer of electronic equipment. Alpha Corporation sells its products in the U.S. (through a U.S. branch) as well as worldwide. Alpha Corporation also has four non-U.S. subsidiaries, B Corporation, C Corporation, D Corporation, and E Corporation, which act as distributors for Alpha's products in countries other than the U.S.

Alpha's income for the 1992 income year consists of:

	Sales	Gross Profit
Non U.S. Sales Income	$100,000,000	$20,000,000
U.S. Sales income	60,000,000	12,000,000
Dividends from B,C,D, & E		7,000,000
Fees from C for services		1,000,000
Total Gross Profit		$40,000,000

Among other deductions, Alpha incurs the following expenses:

Expenses of international department	$1,600,000
Personnel department expenses	50,000
Training department expenses	35,000
General and administrative	55,000
President's salary	40,000
Sales manager's salary	20,000
Total	$1,800,000

Expenses of International Department

The international department performs two principle types of activities:

- The department provides services for the direct benefit of C for which it receives a fee of $1 million.

- The department also engages in stewardship activities in the nature of management review which duplicates functions performed by the subsidiaries. For example, a team of internal auditors from Alpha's accounting department periodically audits the subsidiaries books and prepares internal reports for use by Alpha management. Similarly, Alpha's treasurer periodically reviews the subsidiaries' financial policies for Alpha's board of directors. The cost of the duplicative services is $600,000.

The other listed expenses (e.g., personal department, training, etc.,) are supportive expenses with respect to Alpha's worldwide manufacturing and sales activities.

For purposes of applying the Treasury Regulation §1.861-8 allocation and apportionment rules, Alpha's statutory grouping is all gross income meeting the ECI standard. The residual grouping is gross income not meeting the ECI standard. For purposes of determining California's statutory and residual groups, the federal groupings would apply since all of Alpha's U.S. source income is ECI (i.e., Alpha does not have any U.S.-source noneffectively connected business income). The allocation and apportionment process is used to determine the deductions attributable to these two groupings.

Step 1 - Allocation:

The international department's outlay of $1 million is the basis for the charge to C for services rendered. Therefore, the $1 million expense is allocated to the fee income from C. The remaining $600,000 of the department's deductions are definitely related and allocable to the types of gross income to which they give rise, namely dividends from subsidiaries B, C, D, and E.

The supportive expenses are definitely related and allocable to the sales income derived from both U.S. and foreign markets.

Step 2 - Apportionment:

The $1.6 million of expenses of the international department are allocable to classes of income (dividends and service fees) which are solely within the residual grouping. There is therefore no need to apportion these expenses. They are simply 100% allocated to the residual grouping and not deductible from ECI.

Since the $200,000 in supportive expenses are definitely related to a class of gross income (sales) which consists of both statutory (ECI) and residual (non-ECI) groupings, the expenses must be apportioned between the two groupings. In the absence of any other facts (such as time records for the employees), an acceptable method of apportionment would be on the basis of gross receipts.

Statutory Grouping (ECI):

$$\frac{\$60{,}000}{\$100 \text{ million} + \$60 \text{ million}} \times \$200{,}000 = \$75{,}000$$

Thus, Alpha can reduce its income effectively connected with its U.S. business by $75,000, even though the deduction reflects disbursements mainly in the foreign country.

Example 3:

Alpha Corporation, a foreign corporation doing business in the U.S., is a manufacturer of electronic equipment. Alpha Corporation sells its products in the U.S. (through a U.S. branch) as well as worldwide. Alpha Corporation also has four non-U.S. subsidiaries, B Corporation, C Corporation, D Corporation, and E Corporation, which act as distributors for A's products in countries other than the U.S. Alpha also made a substantial investment in California municipal bonds. The bonds come due in 1998, and Alpha intends on using the proceeds for future expansion of its U.S. business activities.

A's income for the 1995 income year consists of:

	Sales	Gross Profit
Non-U.S. sales income	$100,000,000	$20,000,000

U.S. sales income	60,000,000	12,000,000
Dividends from B,C,D, & E		8,000,000
Interest income from U.S. Bank		2,000,000
Interest income from U.K. Bank		1,000,000
Interest from CA Municipal Bonds		4,000,000
Fees from C for services		1,000,000
Total gross profit		$47,000,000

The U.S. sales income is effectively connected with Alpha's U.S. trade or business. The interest income from U.S. Bank is also effectively connected with Alpha's U.S. trade or business, while the interest income from U.K. Bank is not. The interest from the California municipal bonds are not effectively connected with Alpha's U.S. trade or business, but represent U.S.-source business income.

Among other deductions, Alpha incurs the following expenses:

Expenses of International Department	$1,600,000
Treasury and Finance Department	100,000
Personnel department expenses	50,000
General and administrative	90,000,000
President's salary	60,000,000
Total	$1,900,000

The international department performs two principle types of activities.

- The department provides services for the direct benefit of C for which it receives a fee of $1 million.
- The department also engages in stewardship activities in the nature of a management review which duplicates functions performed by subsidiaries B, C, D, and E. For example, a team of internal auditors from Alpha's accounting department periodically audits the subsidiaries books and prepares internal reports for use by Alpha's management. Similarly, Alpha's treasurer periodically reviews the subsidiaries' financial policies for Alpha's board of directors. The cost of the duplicative services is $600,000.

The other listed expenses (personal department, treasury department, etc.,) are supportive expenses with respect to Alpha's worldwide manufacturing and sales activities.

For purposes of applying the Treasury Regulation §1.861-8 allocation and apportionment rules to determine a "deemed subsidiary's" income includible in a water's-edge combined report for income years beginning on or after January 1, 1992, Alpha's statutory grouping is all gross income meeting the ECI standard, and all U.S.-source noneffectively connected business income. The residual grouping is all other gross income. The allocation and apportionment process is used to determine the deductions attributable to these two groupings.

Step 1 - Allocation:

The international department's outlay of $1 million is the basis for the charge to C for services rendered, and therefore the $1 million expense is allocated to the fee income from C. The remaining $600,000 in the department's deductions are definitely related and allocable to the types of gross income to which they give rise, namely dividends from subsidiaries B, C, D, and E.

The supportive expenses are definitely related and allocable to the sales and interest income derived from both U.S. and foreign markets.

Step 2 - Apportionment:

The $1.6 million of expenses of the international department are allocable to classes of income (dividends and service fees) which are solely within the residual grouping. There is therefore no need to apportion these expenses. They are simply 100% allocated to the residual grouping and not deductible from income includible in the water's-edge combined report.

Since the $300,000 in supportive expenses are definitely related to a class of gross income (sales and interest income) which consists of both statutory (ECI and U.S.-source noneffectively connected business income) and residual (non-ECI and noneffectively connected U.S.-source nonbusiness income) groupings, the expenses must be apportioned between the two groupings. In the absence of any other facts (such as time records for the employees), an acceptable method of apportionment would be on the basis of gross receipts.

Statutory Grouping :

$$\frac{\$60 \text{ million (sales)} + \$6 \text{ million (interest)}}{\$100 \text{ million} + \$60 \text{ million} + \$1 \text{ million} + \$6} \times \$300{,}000 = \$120{,}000$$

million

Thus, Alpha can reduce its income effectively connected with its U.S. business by $120,000, even though the deduction reflects disbursements mainly in the foreign country.

c. Computation Of Interest Expense Under Treasury Regulation §1.882-5 For Income Years Beginning Prior To June 6, 1996

As previously indicated, a significant number of foreign entities filing federal Form 1120F are either foreign banks or real estate investment corporations. Accordingly, for many of these companies interest expense will be one of the largest deductions, and one of the most material expenses to be allocated and apportioned to ECI.

The IRS issued new regulations under IRC Section 882, which are effective for income years beginning on or after June 6, 1996. This section discusses both the pre-1996 and post-1996 rules for purposes of computing the allowable interest deduction.

Treasury Regulation §1.882-4(c) provides that the method of determining the interest deduction allowed a foreign corporation under IRC §882(c) is set forth in Treasury Regulation §1.882-5. It is the position of the IRS that a foreign bank/corporation may not use any other method for determining interest expense effectively connected to its U.S. trade or business. Some taxpayers argue that certain older tax treaties (the U.K. treaty, for example) provide an alternative method which they are entitled to use, the separate accounting method. The basis for this argument is that some treaties provide that profits of a permanent establishment are to be determined as if it were an independent entity dealing at arm's-length with other branches of the same entity. Under this separate accounting method, the bank/corporation deducts the interest expense recorded on its separate books and records, <u>including any interest expense from inter-branch loans.</u>

It is the IRS' position that the <u>method</u> of allocating interest expense is to be determined under U.S. law, which requires the use of the methods set forth in Treasury Regulation §1.882-5.[61] Since the water's-edge deemed subsidiary provision tie directly to the concept of taxable ECI under the federal income tax laws, the FTB will follow the IRS' position that only the methods in Treasury Regulation §1.882-5 may be used to determine interest expense deductible in determining ECI and U.S.-source noneffectively connected business income includible in the water's-edge combined report.

The computation of interest expense attributable to U.S. business income under Treasury Regulation §1.882-5 is complicated, consisting of three basic steps: 1) determining effectively connected assets (ECA); 2) determining the effectively connected liabilities (ECL); and 3) determining the interest deduction allowed.[62] Before discussing these three steps, it will be helpful to define a few terms and rules that are common to all the steps.

1. Classification of items - The classification of items as assets or liabilities must be on a consistent basis from year-to-year and must be substantially in accordance with U.S. tax principles.[63] In other words, the determination of whether items reported on the foreign entity's balance sheet represent assets or liabilities is made by applying U.S. tax principles. Thus, for example, items such as unfunded pension reserves which are not considered liabilities for U.S. tax purposes are not considered liabilities for purposes of applying the provisions of Treasury Regulation §1.882-5.

2. Average total values – An average total value of assets or an average total value of liabilities is determined by taking the average of the totals computed at the most frequent, regular intervals (such as daily, weekly, monthly, or quarterly) for which data for all assets or liabilities is reasonably available.[64]
3. Inter-branch loans – Assets, liabilities, and interest expense amounts resulting from loans or credit transactions of any type between the separate branches of the same corporation are disregarded.[65]

4. Currency Translations - An asset or liability amount that is denominated in one currency is translated into another currency at the exchange rates required under the provisions of IRC §985-§989, which is generally the weighted average exchange rate for the year. Although the Treasury Regulation §1.882-5 have not as yet been revised to cross-reference to IRC §985-§989, the IRS has informally indicated that Treasury Regulation §1.989 does govern translations for purposes of Treasury Regulation §1.882-5. In addition, the proposed Treasury Regulation §1.882-5 regulations cross-reference to Treasury Regulation §1.989(b)(1).

STEP 1: ASSET DETERMINATION

The first step, asset determination, involves the determination of the average total value of assets of the bank or corporation that have produced, do produce, or could reasonably be expected to produce effectively connected income, gain,

or loss. This amount is referred to as ECA. The average total value must be stated in U.S. dollars.[66] All assets must be valued at either U.S. tax book value or FMV. Once an asset valuation method is chosen, it must be used for all subsequent years unless IRS consents to a change.[67] Note that for California purposes for income years beginning on or after January 1, 1992, ECA would include assets of the bank or corporation that have produced, do produce, or could reasonably be expected to produce ECI, gain or loss, and noneffectively connected U.S.-source business income.

Some judgement is obviously required to complete the first step since the regulatory language of what assets are to be included is quite broad. This is also a very important step since the higher the amount of ECA, the higher the amount of the resulting deduction for interest expense. Taxpayers can be expected to treat as many assets as possible as ECA. One audit technique, therefore, would be to have the taxpayer provide a detailed breakdown of assets and the income they generate. If some of the assets are not generating income or the average yield for a category of assets is unusually low in comparison to other assets, there may be assets included in the taxpayer's ECA computation that are not generating income includible in the water's-edge combined report. What may seem to be a relatively minor adjustment to the amount of ECA can generate a comparatively large change in the amount of the allowable interest expense deduction.

For income years beginning prior to January 1, 1992, a 1989 IRS Technical Advice Memorandum is relevant to the asset determination issue.[68] The Technical Advice Memorandum discusses the case of a U.S. branch of a foreign bank which attempted to increase its amount of effectively connected assets by the amount it cost the home office to purchase another U.S. bank through an intermediary holding company. To support the treatment of the stock in the U.S. subsidiary as an effectively connected asset, the taxpayer stated that the U.S. subsidiary was purchased to support the operation of the U.S. branch. It was, however, also repeatedly stressed during the course of the examination that the business of the acquired subsidiary, a retail banking operation, was totally independent of the wholesale operation of the U.S. branch.

The subsidiary was not purchased by the U.S. branch and, as a result, the asset did not appear on the branch's balance sheet. Finally, upon request the taxpayer provided a copy of the application to the Federal Reserve Board in which the home office had stated that at the time of the purchase the purpose of the

acquisition was principally one of investment. Based on this information, the IRS examiner took the position that any potential income from the subsidiary (e.g., dividends) would be FDAP and not ECI. IRS National Office fully supported the position of the examiner to exclude the value of the subsidiaries stock from the average total value of ECA. The facts in this Technical Advice serve to demonstrate that taxpayers may take aggressive positions in classifying assets as effectively connected with the U.S. trade or business.

Another potential issue in the determination of ECA is the averaging method used by the taxpayer. The Treasury Regulation requires that average values be computed at the most frequent intervals reasonably available. If the taxpayer is using monthly averages, or a simple beginning and end-of-year average, the ECA amount may be distorted. If end-of-month or end-of-year balances are high, creating an increased average asset value, (e.g., what if large overnight investments are made, or by what if the home office transfers loans to the U.S.). A review may be needed if the activity in the various asset accounts reveals a significant fluctuation in activity. Or, it may be necessary to use daily balances for the asset determination to "even out" the effects of extraordinary or unusual transactions. With respect to foreign banks, it is the IRS' audit position that since daily asset balances must be maintained for regulatory purposes, foreign banks must use daily averages to compute ECA.

In summary, the taxpayers computation should be carefully reviewed to insure that:

- Assets values are stated on a U.S. tax accounting basis. If the taxpayer has elected to state assets at U.S. tax book value (e.g., net basis), the amounts should be stated net of any contra asset accounts such as reserves for depreciation and bad debts.

- Average total value of assets are computed at the most frequent intervals available, preferably using daily balances if the information is available.

- All assets included in the ECA computation either currently produce, have produced, or can reasonably be expected to produce ECI for income years beginning prior to January 1, 1992. For income years beginning on or after January 1, 1992, all assets in the ECA computation either currently produce, have produced or can reasonably be expected to produce either ECI, or U.S.-source noneffectively connected business income.

- Inter-branch loans and intercompany loans to more than 50 percent owned foreign subsidiaries have been eliminated from the ECA determination. Treasury Regulation §1.882-5 specifically requires the elimination of inter-branch loans. Intercompany company loans to more than 50% owned foreign subsidiaries are eliminated from the ECA determination as a result of the provisions of IRC §864(c)(4)(D). This section provides that foreign-source interest received from a foreign subsidiary owned more than 50% may not be treated as ECI. (Any interest received from a foreign corporation would be considered foreign-source under the general interest-sourcing rule.) Since interest received on loans to more than 50% owned foreign subsidiaries may not be considered ECI under IRC §864(c)(4)(D), the underlying loan cannot reasonably be expected to produce ECI or any other U.S.-source income and therefore cannot be considered an ECA.

STEP 2: LIABILITY DETERMINATION

The second step in the computation is the determination of liabilities effectively connected with the bank or corporation's U.S. trade or business (ECL). This step can be fairly complicated. The bank or corporation determines ECL by multiplying the average total value of ECA as calculated in Step 1 by one of two ratios -- a fixed ratio or an actual ratio. The bank or corporation elects which ratio it wishes to use on its first return to which Treasury Regulation §1.882-5 applies. The bank or corporation must continue to use that ratio for all subsequent years unless the IRS consents to a change.[69]

The ECL computation essentially determines the amount of average ECA, which are deemed funded by debt, (as will be seen in Step 3). An interest rate is then applied to this deemed debt funding to arrive at the amount of deductible interest expense.

The fixed ratio is 50 percent for all corporations except for a U.S. banking or financing business. For banking and financing businesses, the ratio is 95 percent. The definition of a banking and financing business is the same one used for purposes of determining if income from stocks and securities is effectively connected with a U.S. banking or financing business. (See the discussion in Part 3A of Section 8.5(c), Water's-Edge Manual.)

The actual ratio is the ratio of the average total amount of corporate worldwide liabilities for the year (including those of the U.S. trade or business) to the average total value of corporate worldwide assets for the year (including those of the U.S. trade or business). For purposes of computing this ratio, all asset values and liability amounts must be consistently stated from year-to-year in either U.S. dollars or in the currency of the country in which the head office of the corporation is located.[70] The amounts must also be accounted for applying U.S. tax accounting principles. The worldwide assets values must be determined using the same book value or FMV basis that the taxpayer elected for valuing U.S. assets in Step 1.

Example 4:

Big Bucks Bank, a Hong Kong corporation, has a U.S. branch office engaged in the banking business. Big Bucks elects to use adjusted book values for its assets. It also elects to state its accounts for the Step 2 computation in U.S. dollars. The average total value of its corporate worldwide assets is $100 million; the average total value of ECA is $20 million; and the average total amount of corporate worldwide liabilities is $80 million.

Based on these facts, Big Bucks fixed ratio is 95 percent and its actual ratio is 80 percent ($80/$100). U.S. ECL would be $19 million ($20 million x 95%) if the fixed ratio were used and $16 million ($20 million x 80%) if the actual ratio were used.

Some of the same issues that arise in computing ECA will also arise if the taxpayer has elected to use the actual ratio. The taxpayer's goal in computing the actual ratio is to increase the numerator (liabilities) and decrease the denominator (assets) as much as possible to increase the actual "debt to asset" ratio and thereby increase the amount of ECL.

As in Step 1, average worldwide assets and liabilities should be computed at the most frequent intervals reasonably available. Most corporations should have annual financial statements; interim worldwide statements may not be available (unlike interim statements which should be readily available for the U.S. branch activities). When financial statements are available on a quarterly or semiannual basis, they should be used. As noted in the ECA discussion, if the balance sheet is inflated by year-end adjustments, the actual ratio may be distorted by use of a simple beginning and end-of-year average.

With respect to stating the worldwide assets and liabilities on a U.S. tax accounting basis, there are some general principles which may be applied to more closely approximate a balance sheet on a U.S. accounting basis. You should already be used to making this kind of analysis on a worldwide basis to properly reflect worldwide income and factors on a California tax accounting basis. The following are some possible areas of adjustment.

1. Amounts Reflected On U.S. Tax Basis

Many foreign countries allow hidden contingent liability reserves, unfunded pension reserves, unrealized write-offs, or re-valuations of assets, or other similar items to be recorded on the financial statements. Any such account or adjustment, which would not be recognized under U.S. tax principles, should be backed out of the computation of worldwide assets and liabilities.

Similarly, some foreign country financial statements treat the reserve for bad debts as a liability account. For U.S. purposes, the bad debt reserve is a contra-asset account. Therefore, the bad debt reserve should decrease asset values (assuming the taxpayer has not elected to state assets at FMV) and should be eliminated from the amount of liabilities.

2. Exclusion Of Accounts

Memorandum accounts, i.e., those accounts which are recorded both on the asset and liability side of the balance sheet, should be excluded from the computation. These would include items such as forward contracts in foreign exchange, prepaid income with an offsetting liability account, and customers liabilities (where, for example, the taxpayer is merely acting as an agent for another party, such as a tax collecting agent for a government).

3. Inclusion Of Omitted Assets And Liabilities

The worldwide balance sheet of some foreign banks/corporations may not include the assets and liabilities of their branches outside the country of incorporation. Branches outside the country of incorporation may be treated as if

they were subsidiaries, and only the net investment is recorded on the books of the home office. Such treatment would, of course, understate the amount of worldwide assets and liabilities. In such cases, the balance sheets of all foreign branches of the entity should be obtained, converted into the home country currency, and added to the worldwide balance sheet.

STEP 3: INTEREST DEDUCTION ALLOWED

The third step is the computation of the interest deduction allowed against ECI. There are two methods for determining the allowed interest expense deduction – the branch book/dollar pool method or the separate currency pools methods. The bank or corporation elects which method it wishes to use on its first return to which Treasury Regulation §1.882-5 applies. The bank or corporation must continue to use that method for all subsequent years unless the IRS consents to a change.[71]

You may encounter situations where the corporation has failed to elect either of these methods on the first return to which TreasRegs. §1.882-5 applies because it is claiming a "tax treaty" method for computing interest instead of the methods in TreasRegs. §1.882-5. It is the IRS' position that such corporations can only elect one of the methods in TreasRegs. §1.882-5 if such election is made on an amended return filed prior to the start of an audit. If such an election is not made prior to the start of an audit, the IRS at audit selects the method for the taxpayer. FTB will follow the IRS' position that the taxpayer may not make a TreasRegs. §1.882-5 election subsequent to the commencement of an audit.

A. Branch Book/Dollar Pool Method

The branch book/dollar pool method is itself divided into two parts. To determine which part to use, the taxpayer must compare its ECL as calculated in Step 2 to the liabilities the U.S. branch carries on its books (stated in U.S. dollars). It is highly unlikely that ECL would ever exactly equal the amount of liabilities on the U.S. branch's books.

If the branch's liabilities as reflected on its books are greater than the ECL determined under Step 2, the taxpayer uses one method to determine its interest deduction. If, however, the branch's booked liabilities are less than the ECL

determined under Step 2, the taxpayer uses a completely different method to calculate its interest deduction.

i. Booked Liabilities Are Greater Than U.S. ECL Under Step 2:

If the branch's liabilities reflected on its books are more than the U.S. ECL determined under Step 2, the interest deduction is determined using the following formula:

Average U.S. connected Interest rate	X	Average U.S. liabilities Under Step 2	=	Interest Deduction

The average U.S. connected interest rate is equal to the ratio of the total amount of interest expense shown on the branch's books for the year to the average total amount of liabilities shown on the branch's books for the year. Both the numerator and denominator of this ratio must be stated in U.S. dollars.[72]

Example 5

The branch books of Big Bucks Bank reflect total interest expense of $4 million and total liabilities of $38 million. Therefore, the average U.S. connected interest rate is 10.5 percent. If Big Bucks Bank U.S. connected liabilities determined under Step 2 is $30 million, the allowable interest deduction is $3,150,000, even though the amount shown on the U.S. branch's books is $4 million.

In order to maximize their interest deduction, the taxpayer's goal may be to increase the numerator and decrease the denominator of the ratio to increase the effective U.S. interest rate. Keeping these goals in mind, the following audit issues might arise in the computation of the U.S. connected interest rate:

- Interest Expense Amount. Does booked interest expense include items that are not truly interest? For example, it is the position of the IRS that interest rate swap payments are not interest expense/income. Such amounts should, therefore, be eliminated from the numerator of the computation.
- Liabilities Amount. Many of the issues discussed above with respect to the Step 2 computation will also be an issue in the computation of the U.S. interest rate. Has the average amount included in the denominator of the ratio been computed at the most frequent intervals available? Has the U.S.

branch transferred liabilities off-shore (either to the home office or another branch or affiliate) to reduce the amount of U.S. booked liabilities?

ii. Booked Liabilities Are Less Than U.S. ECL Under Step 2:

If the branch's liabilities reflected on its books are less than the ECL determined under Step 2, the interest expense deduction on is the sum of:

- the interest reflected on the branch's books, plus

- the excess of ECL over branch book liabilities multiplied by the average interest rate on U.S. dollar liabilities carried on the books of the non-U.S. offices or branches of the corporation.[73] If the bank or corporation cannot reasonably obtain information providing the actual average interest rate on U.S. liabilities booked by non-U.S. branches, the bank or corporation may use some reasonable method, consistently applied from year-to-year, to estimate the actual interest rate. The regulation indicates, for example, that reference to quoted London inter-bank offered rates (LIBOR) for time deposits with 30 days to maturity may be an appropriate rate.

If the U.S. dollar liabilities carried on the books of the non-U.S. branches are de minimis, then the bank or corporation would simply multiply its total U.S. ECL by the average U.S. connected interest rate (as defined in Part A.i. above).

Example 6:

Big Bucks Bank, a Swiss corporation engaged in the banking business, has a U.S. branch, BBB U.S., and is a calendar year taxpayer. For 1991, BBB U.S. has elected to use the branch book/dollar pool method to determine the amount of deductible interest expense. Big Bucks determines that the average total value of its ECA is $15 million (Step 1).

Big Bucks has elected to use the actual ratio rather than the fixed ratio. For 1991, the average total amount of its worldwide liabilities is $125 million and the average total value of its worldwide assets is $130 million. Big Bucks actual average worldwide liabilities to assets ratio is thus 96.15% ($125/$130). Thus, the amount of Big Bucks U.S. ECL is equal to $15 million x 96.15%, or $14,422,500 (Step 2).

For 1991, the average total amount of liabilities shown on the books of BBB U.S. is $10,000,000. Because BBB U.S.'s U.S. ECL are greater than the average amount of BBB U.S.'s total booked liabilities on its U.S. branch books, BBB U.S. must use Treasury Regulation §1.882-5(b)(3)(i)(B) to compute its allowable interest deduction. For 1991, BBB U.S.'s book interest expense is $950,000 and the average interest rate incurred by BBB's non-U.S. branches on U.S. dollars is 9.97% percent. BBB U.S.'s deductible interest expense is computed as follows:

Interest expense reported on BBB U.S.'s books	$950,000
Interest expense on ECL in excess of BBB U.S.'s liabilities recorded on the U.S. books ($14,422,500 - $10,000,000 X 9.97%)	441,000
BBB U.S.'s Interest Deduction	$1,391,000

In summary, under the branch book/dollar pool method, the corporation can deduct interest attributable to its U.S. ECL. The interest actually shown on the branch's books is primarily relevant for establishing the U.S. connected interest rate.

B. Separate Currency Pool Method

The separate currency pool method is primarily for interest expense paid to banks. It allows the interest deduction to be separately calculated for each currency in which the U.S. branch has borrowed. For each currency, the allowed interest deduction is equal to the product of the following three calculations:

1. The ratio of the ECL determined under Step 2 to the average total amount of liabilities in all currencies shown on the books of the U.S. branch. The numerator of this ratio (U.S. ECL under Step 2) is stated in U.S. dollars. The denominator of this ratio (U.S. booked liabilities in all currencies) may be stated either in U.S. dollars or in the currency of the country in which the head office of the foreign corporation is located.[74]

2. Although the regulation's allowance of the somewhat strange mixing of currencies in determining the ratio would seemingly result in a meaningless number, mathematically you get the same interest deduction amount as

would result from stating all amounts in steps 1 and 2 in U.S. dollars. (You are effectively dividing the amounts stated in the common foreign currency and multiplying the result by the U.S. ECL stated in U.S. dollars.)

3. The average total amount of liabilities on the books of the U.S. branch denominated in the particular currency. This amount must be stated in the same currency as the denominator of the ratio described in 1 above.[75] The average worldwide interest rate for that particular currency. This rate is equal to the ratio of the total amount of interest expense for the year incurred by the corporation (including the U.S. business) with respect to liabilities denominated in the particular currency to the average total amount of liabilities of the corporation (including the U.S. business) for the year denominated in that currency. The interest expense and liabilities are to be stated in the particular currency at issue.[76]

If the average total amount of liabilities in a particular currency (other than the home office currency) is less than 3 percent of total liabilities, the corporation may elect to use the average worldwide interest rate determined in calculation 3 above for U.S. dollars as the average worldwide interest rate for all currencies. Once made, the election may not be changed for subsequent taxable years without the consent of the IRS. This election may not be made for liabilities in the home office currency.[77]

In summary, the separate currency pool method determines the interest deduction for <u>each currency</u> using the following formula. The total interest deduction is the sum of the separate interest deduction for each currency.

U.S. Connected		Avg. total liabilities		Avg. worldwide interest
<u>Liabilities</u>	X	Of particular currency	X	Rate for particular currency
Avg. total liabilities		On branch books		On branch books

<u>Example 7</u>:[78]

Big Bucks Bank, a Swiss corporation engaged in the banking business, has a U.S. branch, BBB U.S., and is a calendar year taxpayer. For 1991, BBB U.S. has liabilities on its books denominated in U.S. dollars, Swiss francs, and Deutsche Marks, as set forth in the following table (amounts in 000's):

<u>Big Bucks Bank</u>

Type of Debt	Amount	Amount	InterestPaid	AverageRate

	ofBBB-U.S.Debt	ofWorldwide Debt	Worldwide	Of Interest
U.S. $	$7500	$25,000	$2,438	9.75%
Deutch mark	DM4500	DM5,000	300	6.00%
Swiss franc	SF2000	SF60,000	8,400	14.00%

Big Bucks has elected to use the separate currency pool method to determine the U.S. branch allowed interest deduction. Big Bucks determines that the average total value of its ECA is $15 million (Step 1).

Big Bucks has elected to use the actual ratio rather than the fixed ratio. For 1991, the average total amount of its worldwide liabilities is $125 million and the average total value of its worldwide assets is $130 million. Big Bucks actual average worldwide liabilities to assets ratio is thus 96.15% ($125/$130). Thus, the amount of Big Bucks U.S. ECL is equal to $15 million x 96.15%, or $14,422,500 (Step 2).

The total allowed interest deduction for BBB-U.S. is determined as follows:

US$	$14,422,500 / SF20,000,000	X	SF15,000,000	X	9.75%	=	$1,054,645
DM	$14,422,500 / SF20,000,000	X	SF3,000,000	X	6%	=	129,803
SF	$14,422,500 / SF20,000,000	X	SF2,000,000	X	14%	=	201,917
BBB U.S.'s Interest Deduction							$1,386,365

(1) SF amount determined by converting $7.5 million to francs at an assumed exchange rate of 2 to 1.
(2) SF amount determined by first converting DM 4,500 to U.S. $ using an assumed exchange rate of 3 to 1. That figure was then converted to SF using the 2 to 1 exchange rate.

(3) SF 20,000,000 represents the sum of U.S. $, DM and SF liabilities stated in SF (i.e., $15,000,000+$3,000,000+$2,000,000).

This section is currently under revision and should not be relied upon. □

d. Computation Of Interest Expense Under Treasury Regulation §1.882-5 For Income Years Beginning On Or After June 6, 1996

This section is currently under revision and should not be relied upon.

1. In General

Revised Treasury Regulation §1.882-5 was issued effective for income years beginning on or after June 6, 1996.[79] The revised Treasury Regulation clearly states that it is the exclusive method that may be used to determine a foreign corporation's interest expense effectively connected to its U.S. trade or business. The prior issue of whether older tax treaties, such as the U.K. treaty, provides alternative methods to compute the allowable interest expense deduction is no longer an issue. The revised regulations clearly dispel this notion by stating there are no other available methods to compute interest expense of a foreign corporation.[80]

Direct allocations of interest expense to U.S. asset and indebtedness that meet the requirements in Treasury Regulation §1.861-10T(b) and (c), as limited by Treasury Regulation §1.861-10T(d)(1), may be made in accordance with Treasury Regulation §1.861-10T.[81] However, the interest expense, assets and liabilities which related to the interest expense that was directly allocated will be disregarded in the interest expense computation under §1.882-5.[82] A similar rule applies to a foreign corporation that is a partner in a partnership that has U.S. asset and indebtedness that meets the requirements of in Treasury Regulation §1.861-10T(b) and (c).[83]

The revised regulations also provide that in no event may the interest expense computed under Treasury Regulation §1.882-5 exceed the amount of interest expense paid or accrued by the taxpayer within the income year.[84] Furthermore, any provision that disallows, defers or capitalizes interest expense applies <u>after</u> determining the amount of interest expense allocated to ECI. For example, interest expense disallowed under IRC Section 163(j), deferred under IRC Sections 163(e)(3) or 267(a)(3), or capitalized under IRC Section 263A, would not be considered in the computation of interest expense allocable to ECI under Treasury Regulation §1.882-5.[85]

<u>Example 8:</u>[86]

FC is a foreign corporation, resident in Country X, that is actively engaged in the banking business in the U.S. through a permanent establishment, B. The tax treaty in effect between Country X and the U.S. provides that FC is not taxable on foreign source income earned by its U.S. permanent establishment. In its 1997 tax year, B earns $90 of U.S.-source income from U.S. assets with an adjusted tax basis of $900 and $12 of foreign-source interest income from U.S. assets with an adjusted tax basis of $100. FC's U.S. interest expense deduction, computed in accordance with TreasRegs. §1.882-5, is $500.

Under TreasRegs. §1.882-5(a)(5), FC is required to apply any provision that disallows, defers, or capitalizes interest expense after determining the interest expense allocated to ECI under TreasRegs. §1.882-5. IRC Section 265(a)(2) disallows interest expense that is allocable to one or more classes of income that are wholly exempt from taxation under subtitle A of the IRC. Treasury Regulation §1.265-1(b) provides that income wholly exempt from taxes includes both income excluded from tax under any provisions of subtitle A and income wholly exempt from taxes under any other law. IRC Section 894 specifies that the provisions of subtitle A are applied with due regard to any relevant treaty obligation of the U.S. Because the treaty between the United States and Country X exempts foreign-source income earned by B from U.S. tax, FC has assets that produce income wholly exempt from taxes under subtitle A, and must therefore allocate a portion of its Treasury Regulation. §1.882-5 interest expense to exempt income. Using this methodology, the amount of disallowed interest expense is calculated as:

$$\$500 \times \frac{\$100 \text{ Treaty-exempt U.S. assets}}{\$1{,}000 \text{ Total U.S. assets}} = \$50.00$$

Therefore, FC deducts a total of $450 ($500-$50) of interest expense attributable to its ECI in 1997. For California purposes, this allocation will only be necessary when exempt income is excluded from the combined report. For example, if the allocation relates to tax exempt interest income, California includes tax exempt interest income in the combined report. Accordingly, this allocation would not be required. However, if the allocation relates to a treaty-based exclusion of income for income years beginning prior to January 1, 1992, then an allocation between exempt and taxable income would be required.

2. Making An Election Under Treasury Regulation §1.882-5

A corporation must make each election required by Treasury Regulation §1.882-5 on the corporation's federal Form1120F for the first income year beginning on or after the date of this revised regulation. An election cannot be made on an amended return. The election is made by using the method elected to calculate interest expense claimed on the original return for the year. An elected method must be used for a minimum period of five years before a taxpayer may elect a different method. A change in election prior to the end of the five-year period will rarely be granted.[87] If a taxpayer fails to make an election in a timely fashion, then the Assistant Commissioner (International) may make any or all of the elections on behalf of the taxpayer, and the elections shall be binding as if made by the taxpayer.[88]

3. Computing The Allowable Interest Deduction

The computation of interest expense attributable to U.S. business income under Treasury Regulation §1.882-5 remains complicated, although the IRS has attempted to simplify portions of the computation. The computation consists of three basic steps, determining the:

1) Total value of U.S. assets for the income year;
2) Total amount of U.S.-ECL for the income year; and
3) Interest deduction allowed.[89]

The definitions discussed previously have been modified slightly to reflect changes to the regulations and are stated below. The terms and rules are common to all the steps for income years beginning on or after June 6, 1996.

- Classification of items - The classification of items as assets or liabilities must be on a consistent basis from year-to-year, and must be in accordance with U.S. tax principles. The determination of whether items reported on the foreign entity's balance sheet represent assets or liabilities is made by applying U.S. tax principles. Thus, for example, items such as unfunded pension reserves, which are not considered liabilities for U.S. tax purposes, are not considered liabilities for purposes of applying the provisions of Treasury Regulation §1.882-5.

- Average total values - An average total value of assets or an average total value of liabilities is determined by taking the average of the totals computed

at the most frequent, regular intervals for which data are reasonably available. In no event shall the value be computed less frequently than monthly for large banks, and semi-annually by any other taxpayer.[90] (Note that the averaging under the new rules is substantially less burdensome than the old rules, which required averaging at the most frequent, regular intervals (such as daily, weekly, monthly, or quarterly) for which data for all assets or liabilities was reasonably available.)[91]

- Inter-branch loans - Assets, liabilities, and interest expense amounts resulting from loans or credit transactions of any type between the separate branches of the same corporation are disregarded.[92]

- Currency translations - An asset or liability amount that is denominated in one currency is translated into another currency at the exchange rate consistent with the method the taxpayer uses for financial reporting purposes provided the method used is applied consistently from year-to-year. Interest paid or accrued shall be translated under the rules of Treasury Regulation in §1.988-2.[93] In the event the functional currency of the taxpayer's home office is a hyperinflationary currency, then the taxpayer may be required to make the necessary computations using U.S. dollars if such a method is necessary to prevent distortion.

STEP 1: DETERMINATION OF TOTAL AMOUNT OF U.S. ASSETS.

The first step, asset determination, involves the determination of the average total value of assets of the bank or corporation that produces, or would reasonably be expected to produce, effectively connected income, gain, or loss. This amount is referred to as effectively connected assets (ECA). The average total value must be stated in U.S. dollars.[94] All assets must be valued at either U.S. tax book value or FMV. Once an asset valuation method is chosen, it must be used for all subsequent years unless IRS consents to a change.[95] Note that for California purposes for income years beginning on or after January 1, 1992, ECA would include assets of the bank or corporation that have produced, do produce, or could reasonably be expected to produce effectively connected income, gain or loss, and noneffectively connected U.S.-source business income.

An asset is considered a U.S. ECA to the extent that it is a U.S. ECA under Treasury Regulation §1.884-1(d).[96] Based on this broad definition, U.S. ECA would include:

- U.S. real property held in a wholly-owned domestic subsidiary of a foreign corporation that qualifies as a bank under IRC Section 585(a)(2)(B) (without regard to the second sentence thereof), provided that the real property would qualify as used in the foreign corporation's trade or business;

- Assets that produce income treated as ECI under IRC §§921(d) or 926(b), relating to certain income of a FSC and certain dividends paid by a FSC to a foreign corporation;

- Assets that produce income treated as ECI under IRC section 953(c)(3)(C), relating to certain income of a captive insurance company that a corporation elects to treat as ECI, that is not otherwise ECI; and

- An asset that produces income treated as ECI under IRC Section 882(e), relating to certain interest income of possession banks.[97]

U.S. ECA do not include assets that produce income or gain described in IRC sections 883(a) and (b).[98] Furthermore, the total value of U.S. ECA is reduced by the amount of any additions to the reserve for bad debts, which are allowed as deductions under IRC Section 585.[99] U.S. ECA are generally valued at adjusted basis used for purposes of computing gain or loss from the sale or other disposition of that item.[100] However, the taxpayer may elect to use FMV for purposes of valuing both its assets and liabilities.[101]

As discussed in step 1: Asset Determination, for income years beginning prior to June 6, 1996, some judgement is obviously required to complete the first step since the regulatory language of what assets are to be included is quite broad. However, the new regulations have attempted to simplify the asset determination process by stating that if it is an asset for purposes of Treasury Regulation §1.884-1, then it is a U.S. asset for purposes of this section. The determination of U.S. ECA is a very important step. The higher the amount of ECA, the higher the amount of the resulting deduction for interest expense. One audit technique would be to have the taxpayer provide a detailed breakdown of assets and the income they generate. If some of the assets are not generating income or the average yield for a category of assets is unusually low in comparison to other assets, there may be assets included in the taxpayer's ECA computation that are not generating income includible in the water's-edge combined report. What may seem to be a relatively minor adjustment to the amount of ECA can generate a

comparatively large change in the amount of the allowable interest expense deduction.

Another potential issue in the determination of ECA is the averaging method used by the taxpayer. The new Treasury Regulations are more liberal in requiring no less than monthly averaging for large banks, and semiannually averaging for all other taxpayers for purposes of computing the total value of U.S. assets. If the taxpayer is using monthly averages, or a simple beginning and end-of-year average, the ECA amount may be distorted. If a review of the activity in the various asset accounts reveals a significant fluctuation in activity, it may be necessary to use daily balances for the asset determination to "even out" the effects of extraordinary or unusual transactions. This is only if more frequent averaging data is available.

In summary, the taxpayers computation should be carefully reviewed to insure that:

A. Assets values are stated on a U.S. tax accounting basis. If the taxpayer has elected to state assets at U.S. tax book value (e.g., net basis), the amounts should be stated net of any contra asset accounts such as reserves for depreciation and bad debts.

B. Average total value of U.S. assets are computed at the most frequent intervals available, preferably using daily balances if the information is available.

C. The new regulations require, at a minimum, monthly averaging for large banks, or semi-annual averaging for all other taxpayers.

D. For income years beginning on or after January 1, 1992, all assets in the ECA computation either currently produce, have produced or can reasonably be expected to produce either ECI, or U.S.-source noneffectively connected business income.

E. Inter-branch loans and intercompany loans to more than 50 percent owned foreign subsidiaries have been eliminated from the ECA determination. Treasury Regulation §1.882-5 specifically requires the elimination of inter-branch loans. Intercompany loans to more than 50% owned foreign subsidiaries are eliminated from the ECA determination as a result of the

provisions of IRC §864(c)(4)(D). This section provides that foreign-source interest received from a foreign subsidiary owned more than 50% may not be treated as ECI. (Any interest received from a foreign corporation would be considered foreign-source under the general interest-sourcing rule.) Since interest received on loans to more than 50% owned foreign subsidiaries may not be considered ECI under IRC §864(c)(4)(D), the underlying loan cannot reasonably be expected to produce ECI or any other U.S.-source income. Therefore, it cannot be considered an ECA.

STEP 2: DETERMINATION OF U.S.-CONNECTED LIABILITIES

The second step in the computation of the allowable interest expense deduction is the determination of liabilities effectively connected with the bank or corporation's U.S. trade or business (ECL). This step can be fairly complicated. The bank or corporation determines ECL by multiplying the average total value of ECA as calculated in Step 1 by one of two ratios -- a fixed ratio or an actual ratio. The bank or corporation will either use the actual ratio, or it may elect to use the fixed ratio on its first return to which Treasury Regulation §1.882-5 applies. The bank or corporation must continue to use that ratio for a minimum of five years before the taxpayer can elect another method. Requests to change an election prior to the expiration of the requisite five-year period will rarely be granted by the IRS.[102]

The ECL computation essentially determines the amount of average ECA, which are deemed funded by debt. As will be seen in Step 3, an interest rate is then applied to this deemed debt funding to arrive at the amount of deductible interest expense.

The fixed ratio is 50 percent for all corporations except for a U.S. banking or financing business. For banking and financing businesses, the ratio is 93 percent. The definition of a banking and financing business is the same one used for purposes of determining if income from stocks and securities is effectively connected with a U.S. banking or financing business.[103]

The actual ratio is the ratio of the average total amount of corporate worldwide liabilities for the year (including those of the U.S. trade or business) to the average total value of corporate worldwide assets for the year (including those of the U.S. trade or business). For purposes of computing this ratio, all asset values and liability amounts must be consistently stated from year-to-year in

either U.S. dollars or in the currency of the country in which the head office of the corporation is located.[104] The amounts must also be accounted for on the basis of U.S. tax accounting principles.[105] The worldwide assets values must be determined using the same book value or FMV basis that the taxpayer elected for valuing U.S. assets in Step 1.

Example 9:

Big Bucks Bank, a Hong Kong corporation, has a U.S. branch office engaged in the banking business. Big Bucks elects to use adjusted book values for its assets. It also elects to state its accounts for the Step 2 computation in U.S. dollars. The average total value of corporate worldwide assets is $100 million; the average total value of ECA is $20 million; and the average total amount of corporate worldwide liabilities is $80 million.

Based on these facts, Big Bucks fixed ratio is 93 percent and its actual ratio is 80 percent ($80/$100). U.S. ECL would be $18.6 million ($20 million x 93%) if the fixed ratio were used and $16 million ($20 million x 80%) if the actual ratio were used.

Some of the same issues that arise in computing ECA will also arise if the taxpayer has elected to use the actual ratio. The taxpayer's goal in computing the actual ratio is to increase the numerator (liabilities) and decrease the denominator (assets) as much as possible to increase the actual "debt to asset" ratio and thereby increase the amount of ECL.

As in Step 1, average worldwide assets and liabilities should be computed using, at a minimum, semi-annual computations. In the case of any other taxpayer, the minimum interval allowed is annual averaging. Most corporations should have annual financial statements; interim worldwide statements may not be available (unlike interim statements which should be readily available for the U.S. branch activities). Where financial statements are available on a quarterly or semiannual basis, they should be used. As noted in the ECA discussion, if the balance sheet is inflated by year-end adjustments, the actual ratio may be distorted by use of a simple beginning and end-of-year average.

With respect to stating the worldwide assets and liabilities on a U.S. tax accounting basis, there are some general principles which may be applied to more closely approximate a balance sheet on a U.S. accounting basis. The kind

of required audit analysis needed here is similar to that used when auditing on a worldwide basis to ensure that the combined report computation properly reflects worldwide income and factors on a California tax accounting basis. This discussion is the same as that for income years beginning prior to June 6, 1996.

STEP 3: INTEREST DEDUCTION ALLOWED

The third step is the computation of the interest deduction allowed against ECI. There are two methods for determining the allowed interest expense deduction – the adjusted U.S. booked liabilities method or the separate currency pools methods. The bank or corporation elects which method it wishes to use on its first return to which Treasury Regulation §1.882-5 applies for income years beginning on or after June 6, 1996. The bank or corporation must continue to use that method for a minimum of five income years unless it obtains permission from the IRS to change methods. Requests to change methods prior to the expiration of the requisite five-year period will rarely be granted.[106]

A. Adjusted U.S. Booked Liabilities Method

Under the Adjusted U.S. Booked Liabilities Method, the adjustment to the amount of interest expense paid or accrued on U.S. booked liabilities is determined by comparing the amount of U.S. ECL for the income year, as determined under Step 2, with adjusted U.S. booked liabilities determined under this step.[107] If the amount of U.S. booked liabilities, as determined in Step 2, equals or exceeds the amount of U.S. ECL, as determined in Step 2, then allowable interest expense is determined by multiplying total interest expense paid or accrued on the U.S. books by the ratio of U.S.-ECL to average total U.S. booked liabilities.[108] If the amount of U.S. booked liabilities, as determined in Step 2, is less than the amount of U.S.-ECL, as determined in Step 2, then the allowable interest expense equals the total amount of interest paid or accrued, plus the excess of the amount of U.S. ECL over U.S. booked liabilities multiplied the applicable interest rate.

For purpose of this discussion, the average total amount of U.S. booked liabilities under Step 3 is the liability that is properly reflected on the books of the U.S. trade or business. For entities other than banks, a liability is considered properly reflected on the books of a U.S. trade or business if the liability is secured predominantly by a U.S. asset of the foreign corporation[109], if the foreign

corporation enters the liability on a set of books relating to an activity that produces ECI at a time reasonably contemporaneous with the time at which the liability is incurred[110], or if the IRS determines that there is a direct connect between the liability and the activity that produces ECI.[111] If the foreign entity is a bank, a liability is considered properly reflected on the books of the U.S. trade or business if the bank enters the liability on a set of books relating to an activity that produces ECI before the close of the day on which the liability is incurred and there is a direct connection or relationship between the liability and that activity.

Examples of how to compute the allowable interest deduction under the Adjusted U.S. Booked Liabilities Method can be found under TreasRegs. §1.882-5(d)(6).

B. Separate Currency Pool Method

The separate currency pool method remains substantially the same as the calculation for income years beginning prior to January 6, 1996. Accordingly, due to the complexity of this calculation, it will not be restated. (See Step 3B of Section 8.7(c), Water's-Edge Manual.) However, it is important to point out that new regulations permit taxpayers to elect to use the new separate currency pools method instead of the Adjusted U.S. Booked Liabilities Method in TreasRegs. §1.882-5(d). Taxpayers treat their U.S. assets in each currency as funded by the worldwide liabilities of the taxpayer in the same currency.[112] To prevent distortion, taxpayers that have more than 10% of their U.S. assets denominated in hyperinflationary currency are precluded from using the separate currency pools method.[113] Taxpayers may also convert into U.S. dollars any currency pool in which the foreign corporation holds less than three percent of its U.S. assets.[114]

e. Summary

This section covered the method of determining the expenses allowable in calculating a deemed subsidiary's taxable income includible in the water's-edge combined report. This discussion does not cover state adjustments. This discussion does reflect the difference in federal and California law, which allows deductions against U.S.-source noneffectively connected business income in the taxable income computation effective for income years beginning on or after January 1, 1992. We have now discussed all the pieces of the federal rules needed to compute the includible net income of deemed subsidiaries for California purposes.

1. The amount of allowable expenses other than interest is determined using the allocation and apportionment method set forth in Treasury Regulation §1.861-8.

2. The regulations separate deductions into three categories for the purpose of the allocation and apportionment process:
   a) Deductions definitely related to a class of gross income.
   b) Deductions definitely related to all gross income.
   c) Deductions not definitely related to any gross income.

3. After deductions have been allocated to a class of gross income, the gross income is divided into statutory and residual groupings and the deductions are then apportioned between the groupings.

4. The basis for apportionment of deductions between the groupings is the factual relationship between the deduction and the groupings of gross income.

5. The amount of allowable interest expense is determined using one of two methods set forth in Treasury Regulation §1.882-5. The Treasury Regulation §1.882-5 methods are the only acceptable methods of determining the amount of the allowable interest deduction.

6. The determination of interest is a three step process. Step 1 is the determination of ECA, Step 2 is the determination of ECL, and Step 3 is the determination of the allowable interest deduction.

7. Allowable interest is determined using either the branch book/dollar pool method or the separate currency pool method.

8. Under the branch book/dollar pool method the corporation can deduct interest attributable to its U.S. ECL. The interest actually shown on the branch's books is primarily relevant for establishing the U.S. connected interest rate.

9. Under the separate currency pool method the corporation determines the interest deduction for each currency. The total interest deduction is the sum of the separate interest deduction for each currency.

For more information on the allocation and apportionment of expenses to income includible in the water's-edge combined report, refer to "Allocation and Apportionment of Research and Experimental Expenditures: The Percentage Game or Passing the Buck", Richard A. Gorden, Esq., Et al, August 13, 1993, *Tax Management International Journal,* Vol. 22, No. 8, p.391.

Footnotes

1. R&TC §25110(a)(5)
2. CCR §25110(d)(2)(G)(iii)
3. CCR §25110(d)(2)(iv)
4. IRC §861(b); IRC §882(c); TreasRegs. §1.861-8(c); TreasRegs. §1.882-5.
5. For federal purposes, deductions are allowed in determining taxable ECI. However, no deductions are allowed in determining taxable FDAP income. The auditor will have to determine the appropriate deductions to allocate and apportion to noneffectively connected U.S. source business income since a comparable determination will not be made for federal purposes. Even if a taxpayer reports deductions against FDAP income for California purposes, these deductions will never be subject to a federal examination.
6. TreasRegs. §1.882-4(b)(2)
7. IRC §882(c)(2)
8. TreasRegs. §1.882-4(a)(2) and (3)
9. New Colonial Ice vs. Helvering, 292 U.S. 435 (1934)
10. CCR §25110(d)(2)(G)(iii)
11. TreasRegs. §1.861-8(a)(3)
12. TreasRegs. §1.861-8(a)(4)
13. Ibid, footnote 5
14. TreasRegs. §1.861-8(a)(2) and §1.861-8(b)(1)
15. TreasRegs. §1.861-8(a)(2) and §1.861-8T(c)(1)
16. For California purposes, the federal rules are used for determining the deductions allowed against ECI and U.S.-source, noneffectively connected business income.
17. TreasRegs. §1.861-8(b)(1)
18. TreasRegs. §1.861-8(b)(1)
19. TreasRegs. §1.861-8T(d)(2)
20. TreasRegs. §1.861-8(b)(1)
21. TreasRegs. §1.861-8(b)(5)
22. TreasRegs. §1.861-8(e)(9)
23. TreasRegs. §1.861-8(b)(5)
24. TreasRegs. §1.861-8(b)(2)
25. TreasRegs. §1.861-8T(b)(3)
26. TreasRegs. §1.861-8(e)(4)
27. TreasRegs. §1.861-8(b)(5)

28. TreasRegs. §1.861-8(c)(2&3)
29. TreasRegs. §1.861-8T(c)(1)
30. TreasRegs. §1.861-8(c)(3)
31. TreasRegs. §1.861-8(g), Examples (18) and (19)
32. TreasRegs. §1.861-8T(d)(2)(i)(B)
33. TreasRegs. §1.861-9T(a)
34. TreasRegs. §1.861-8(e)(4)
35. TreasRegs. §1.861-8(e)(3)
36. TreasRegs. §1.861-8(e)(5)
37. TreasRegs. §1.861-8(e)(6)
38. TreasRegs. §1.861-8(e)(7)
39. TreasRegs. §1.861-8(e)(8)
40. TreasRegs. §1.861-8(e)(4)
41. TreasRegs. §1.861-8(g), example 18
42. Revenue Procedure 92-69, 1992-2 CB 435
43. 1992-1 CB 409
44. H Rept No 100-795 (PL 100-647) p. 459; H.R. No 101-247 (PL 100-239) p. 1209
45. CCR §25110(d)(2)(G)(iii)
46. TreasRegs. §1.863-8(e)(3)(i)(A)
47. TreasRegs. §1.861-8(e)(3)(i)(A)
48. TreasRegs. §1.861-8(e)(3)(i)(B)
49. TreasRegs. §1.861-8(e)(3)(ii)(A)
50. TreasRegs. §1.861-8(e)(3)(ii)(A)
51. TreasRegs. §1.861-8(e)(3)(ii)(C) & (D)
52. TreasRegs. §1.861-8(e)(3)(iii)(A)
53. TreasRegs. §1.861-8(e)(3)(iii)
54. TreasRegs. §1.861-8(e)(5)
55. TreasRegs. §1.861-8(e)(5)
56. TreasRegs. §1.861-8(e)(7)(i)
57. Notice 89-58, 1989-21 IRB 23
58. TreasRegs. §1.861-8(e)(8)
59. TreasRegs. §1.989(b)-1
60. TreasRegs. §1.985-1(b)(1)(v)
61. Revenue Ruling 89-115, 1989-2 CB 130; Revenue Ruling 85-7, 1985-1 CB 188; Revenue Ruling 78-423, 1978-2 CB 194.
62. TreasRegs. §1.882-5(b)
63. TreasRegs. §1.882-5(a)(1)
64. TreasRegs. §1.882-5(a)(4)

65. TreasRegs. §1.882-5(a)(5)
66. TreasRegs. §1.882-5(b)(1)
67. TreasRegs. §1.882-5(a)(2)
68. TAM 8948003
69. TreasRegs. §1.882-5(b)(2)
70. TreasRegs. §1.882-5(b)(2)(ii)
71. TreasRegs. §1.882-5(b)(3)
72. TreasRegs. §1.882-5(b)(3)(i)(A)
73. TreasRegs. §1.882-5(b)(3)(i)(A)
74. TreasRegs. §1.882-5(b)(3)(ii)(A)
75. TreasRegs. §1.882-5(b)(3)(ii)(B)
76. TreasRegs. §1.882-5(b)(3)(ii)(C)
77. TreasRegs. §1.882-5(b)(3)(ii)
78. This example is a modified version of that contained in TreasRegs. §1.882-5(c), Example 2. See also Income Taxation of Foreign Related Transactions, Rhodes and Langer, Matthew Bender, 1990, section 2.31.
79. TreasRegs. §1.882-5(f)
80. TreasRegs. §1.882-5(a)(2)
81. TreasRegs. §1.882-5(a)(1)(ii)(A)
82. TreasRegs. §1.882-5(a)(1)(ii)
83. TreasRegs. §1.882-5(a)(1)(ii)(B)
84. TreasRegs. §1.882-5(a)(3)
85. TreasRegs. §1.882-5(a)(5)
86. TreasRegs. §1.882-5(a)(8)Example 4
87. TreasRegs. §1.882-5(a)(7)(i)
88. TreasRegs. §1.882-5(a)(7)(ii)
89. TreasRegs. §1.882-5(b)
90. TreasRegs. §1.882-5(b)(3)
91. TreasRegs. §1.882-5(a)(4)
92. TreasRegs. §1.882-5(b)(1)(iv)
93. TreasRegs. §1.882-5(a)(4)
94. TreasRegs. §1.882-5(b)(1)
95. TreasRegs. §1.882-5(a)(2)
96. TreasRegs. §1.882-5(b)(1)(i)
97. TreasRegs. §1.882-5(b)(1)(iii)
98. TreasRegs. §1.882-5(b)(1)(ii)
99. TreasRegs. §1.882-5(b)(2)(iii)
100. TreasRegs. §1.882-5(b)(2)(i)
101. TreasRegs. §1.882-5(b)(2(ii)

102. TreasRegs. §1.882-5(a)(7)(i)
103. TreasRegs. §1.882-5(c)(4)
104. TreasRegs. §1.882-5(c)(2)(ix)
105. TreasRegs. §1.882-5(c)(2)(ii)
106. TreasRegs. §1.882-5(a)(7)(i)
107. TreasRegs. §1.882-5(d)(1)
108. TreasRegs. §1.882-5(d)(4)
109. TreasRegs. §1.882-5(d)(2)(ii)(1)
110. TreasRegs. §1.882-5(d)(2)(ii)(2)
111. TreasRegs. §1.882-5(d)(2)(ii)(3)
112. TreasRegs. §1.882-5(e))(2)
113. TreasRegs. §1.882-5(e)(4)
114. TreasRegs. §1.882-5(d)(1)(ii)

Section 8.8 Suggested Audit Techniques

Contents:

a. Review The Federal Form 1120F

For every member of the water's-edge group that you have identified that has a federal Form 1120F filing requirement, review the federal Form 1120F and the computation of federal taxable income. You should be able to determine how significant this affiliate's activities are in the U.S., or whether the taxpayer is taking a treaty-based return position. This issue is most likely to be material in the case of foreign banks, although material issues may exist for other corporations as well. Based on this review, you may identify the following types of issues:

1. FDAP Income

If the corporation has reported material FDAP income, you should perform an analysis to determine if such income should be converted to ECI for income years beginning prior to January 1, 1992. The analysis required would be very similar to the type of analysis we currently perform to determine if investment income is business income. For example, obtain a detailed monthly breakdown of the investments and income earned by category. Determine who has authority for making the investments and managing the portfolio, and whether the corporation has a fixed place of business in the U.S. Review the minutes of the bank or corporation's Board of Directors meetings, finance committee meetings, etc., to determine the reason the investments were made. Generally, the asset-use and business-activities tests would be used to determine if the FDAP should have been classified as ECI. Remember, however, the special rules that apply to banks and financials for determining if income from stocks and securities is ECI.

For income years beginning on or after January 1, 1992, you should perform an analysis to verify that all U.S.-source business income, including ECI, is included in the water's-edge combined report. This can be accomplished by reviewing the following information:

1. Federal Form 1120F, Section I, will identify any self-reported FDAP income.

2. Federal Form 5471, Schedule M, will reflect transactions between a controlled foreign corporation (CFC) and either the U.S. shareholders or other related

U.S. persons. FDAP income you may identify from this schedule could include interest, dividends, royalties, rent, etc.

3. Federal Form 5472, part IV, will reflect transactions between the U.S. reporting corporations and the foreign related-party identified on federal Form 5472, part III.

U.S.-source non-ECI is includible in the combined report to the extent it is considered business income. Transactions reported on federal Forms 5471 and 5472 should be analyzed to determine whether there is any U.S.-source income that has not been included in the computation of either FDAP income or ECI for income years beginning on or after January 1, 1992.

2. Treaty Issues

ECI will be reported on federal Form 1120F, Section II. In the event a deemed subsidiary is claiming immunity from taxation because a U.S. tax treaty overrides the IRC, Question W on page 5 of the federal Form 1120F will be marked yes, and the taxpayer will have attached federal Form 8833, Treaty-Based Return Position Disclosure. Federal Form 8833 will disclose the nature and amount of the ECI excluded from federal taxation. You should verify that any amounts excluded from the computation of federal taxable income because of a treaty-based return position claimed for income years beginning on or after January 1, 1992, are included in the water's-edge combined report computation. Tax treaties are no longer followed for those years. For income years beginning prior to 1992, you should verify that the foreign corporation does not, in fact, have a permanent establishment in the U.S. if the potential adjustment is material. However, this issue should not be pursued where the IRS is examining the same issue.

If a foreign corporation with a material amount of U.S.-source income has filed a federal Form 1120F claiming immunity from tax pursuant to a tax treaty, you should familiarize yourself with the provisions of that tax treaty. Should the corporation's activities be elevated to the level of a permanent establishment thereby causing these activities to be includible in the water's-edge combined report?

3. Home Office Expense Allocation

You should determine whether the deemed subsidiary has a material deduction for home office overhead expenses. Review the taxpayer's Treasury Regulation §1.861-8 workpapers to determine how they determined the amount allocable to the U.S. business activities. Obtain a profit and loss statement for the entire entity (not just the U.S. branch), which provides a detailed breakdown of the expenses incurred. Request organization charts, manuals, or other documentation, which detail the functions of the various organizational units. Does the corporation have a unit which could possibly be performing stewardship type of expenses? If so, has the taxpayer identified the amount of expenses attributable to such activities and allocated them to dividend income? The taxpayer should be able to provide a detailed explanation of the nature of all the expenses being allocated to the U.S. branch and that the expenses are in some way related to the U.S. activities.

Some taxpayers may try to argue that they do not have access to the home office records or the type of detailed information needed to verify their allocation. Remember, the burden is on the taxpayer to demonstrate the amount of deductible expenses. Also keep in mind that the IRS has had some success in obtaining access to foreign books and records if those records are needed to substantiate deductions claimed by the branch. See, for example, Hong Kong & Shanghai Banking Corp, 85 TC 701 (1985). Finally, the new IRC §6038A requirements (to which California has conformed) and IRC §6038C should also aid in obtaining access to foreign records, if necessary.

4. Interest Expense Computation

Interest expense will often be a significant deduction in the profit and loss statement. Review the taxpayer's interest expense computation. Ensure the taxpayer has used one of the methods approved in Treasury Regulation §1.882-5. If the taxpayer is arguing that it is allowed to use another method by virtue of a tax treaty, adjustments will be required to re-compute the expense applying one of the methods approved by the regulation.

If the taxpayer is using one of the Treasury Regulation §1.882-5 methods, request the taxpayer's workpapers detailing the computation of the interest

deduction. Once you obtain the workpapers, ask yourself the following questions:

1. After comparing the amount of assets the corporation has classified as U.S. branch assets to the amount of total assets, does the ratio seem unusually high, especially in comparison to the amount of income included in the water's-edge combined report? Perhaps the taxpayers is including other than ECA in the U.S. asset computation, generating a larger interest deduction.

2. Has the taxpayer computed the average amounts on the most frequent basis required? The taxpayer was required to use the most frequent intervals available. (Remember that the averaging under the new rules is substantially less burdensome than the old rules. The old rules required averaging at the most frequent, regular intervals (such as daily, weekly, monthly, or quarterly) for which data for all assets or liabilities was reasonably available. While the new rules allow monthly averaging for large banks and semi-annual averaging for all other entities.)[1]

3. Has the taxpayer used the same asset valuation method from year-to-year? Taxpayers are required to use the same valuation method unless the IRS consents to the change.

4. Are the asset and liability values stated on a U.S. tax accounting basis?

5. Have all the assets that either currently produce, have produced or can reasonably be expected to produce ECI been included in the computation of ECA? Assets that do not meet this criteria should be excluded.

6. Have inter-branch and intercompany loans to more than 50 percent owned foreign subsidiaries been eliminated from the ECA computations? Such loans must be excluded.

7. Have the liabilities been overstated? If liabilities are overstated, the debt-to-asset ratio will be greater than allowable, thereby overstating the allowable interest deduction.

8. Has the taxpayer included memorandum accounts (i.e., accounts that are recorded as both assets and liabilities)? Such accounts are excluded from the computation.

9. Has the taxpayer included the assets and liabilities of all branches in the computation? In some situations, not all branches may be recorded on the worldwide balance sheet. For example, branches outside the country of incorporation may be reflected as investments on the books of the home office. Such treatment will understate worldwide assets and liabilities.

5. Determine Income And Factors Consistently

There will be situations where income is treated in a specific manner for federal purposes. The factors should be determined on a consistent basis with the determination of income. For example, a sale of stock is generally sourced to the location of the sale whereas a sale of real property is sourced to the location of the underlying property. However, IRC §897 provides that the sale of stock is sourced to the location of the underlying U.S. real property, and is taxed as ECI, if the stock is considered a U.S. real property interest. Accordingly, the gain on sale of stock is treated as a sale of the underlying real property, and the sales factor would be determined consistent with the sale of the underlying real property.

b. Identify Non-Filers

For any water's-edge audit, review the intercompany charges for services. This information may be found on federal Forms 5471 or 5472, in the taxpayer's books and records, or discussed in the notes to the financial statements. If a U.S. affiliate is performing services on behalf of its foreign affiliate, you may be able to show that the foreign corporation is effectively engaged in a U.S. business by virtue of the activities of its affiliates.[1]

The federal Forms 5471 and 5472, which are required to be attached to the bank or corporation's federal tax return to report other intercompany payments to foreign affiliates, such as payments for interest, rents, royalties, dividends, etc. In many instances, the recipient of these payments may not be filing a federal tax return since their tax liability was fully paid at-source. Regardless of whether a federal return was filed, however, to the extent such income is considered U.S.-source business income, it should be included in the water's-edge combined report for income years beginning on or after 1/1/92.

If the U.S. entity filing federal Forms 5472 is also a California taxpayer, then the California taxpayer is required to include copies of the federal Forms 5472 filed with the IRS with their California return. Failure to file federal Form 5472 with their California return will subject the taxpayer to a penalty of $10,000 per omitted form unless they can establish reasonable cause. For income years beginning on or after January 1, 1997, federal Forms 5471 are required to be filed with a taxpayer's California return. However, for income years beginning prior to this date, you would have to obtain these forms from the reporting corporation.

Footnotes

1. InverWorld, Inc., et al, v. Commissioner of Internal Revenue, T.C. Memo 1996-301(1996).